Supreme Court, U. S.
FILED
AUG 8 1980
MICHAEL RODAK, JR., CLERK

No. 80-199

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

BERKLEY MACHINE WORKS & FOUNDRY COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D. C.

QUESTIONS PRESENTED

(1) Whether the fact that the appellate court was divided in reversing the United States Tax Court, establishes, as a matter of law, that the appellate court did not have a, "definite and firm conviction", that the trial court was "clearly erroneous" as required under *Commissioner* v. *Duberstein* 363 U.S. 278,291; 80 S.Ct. 1190; 4 L.Ed. § 1218 (1960)?

(2) Since Respondent concedes that Petitioner's entertainment facilities were used, "primarily for the furtherance of its business," (§ 274(a)(B) I.R.C. 1954) and that the expenditures were, "ordinary and necessary" business expenses (§ 162 I.R.C. 1954) and, absent any claim that these facilities were used for personal reasons, does not the appellate court's decision contravene the legislative purpose of § 274 I.R.C. 1954?

(3) Where, as here, the appellate court's findings are contrary to the evidence of record, does this not foreclose a determination that the appellate court had, "definite and firm conviction", that the trial court had made a mistake?

(4) Having conceded that Petitioner did not abuse entertainment deductions, may Respondent, nonetheless, propose income tax deficiencies by means of administrative regulations?

(5) Did not the appellate court's refusal to accept the court's findings of fact, coupled with its failure to view the evidence in a light most favorable to Petitioner, usurp the function of the trial court, contrary to Rule 52(a) Federal Rules of Civil Procedure?

(6) Inasmuch as Treasury Regulation 1.274-5(b)(1)(iv) only required Petitioner to substantiate the, "business relationship" of each person entertained and, since the trial court found, that the persons were employees of Petitioner's corporate customers, did not the appellate court misconstrue these regulations by requiring Petitioner to identify, by name, each employee involved in the entertainment?

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No.

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v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Petitioner, Berkley Machine Works and Foundry Company, prays that a writ of Certiorari issue to review the judgment of the United States Court of Appeals for the 4th Circuit entered in the above-entitled cause on June 2, 1980 which reversed a judgment entered on June 13, 1977 by the United States Tax Court.

OPINIONS BELOW

The Findings of Fact and Memorandum Opinion of the United States Tax Court (App. A, infra., pp. 1a to 31a incl.) is unofficially reported in T.C. Memorandum Decisions, Vol.46, Prentice-Hall. The opinion of the United States Court of Appeals for the 4th Cir-

cuit (App. B, infra. pp. 32a to 50a incl.) is reported in —— Fed. 2d ——.

JURISDICTION

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES, TREASURY REGULATIONS AND RULE INVOLVED

The statutory provisions, Treasury Regulations and Rules involved are:

Sections 162(a) and 274 I.R.C. 1954

Treasury Regulations,

§ 1.274-2(c)(3)
§ 1.274-2(c)(4)
§ 1.274-2(4)(i) and (iii)
§ 1.274-5(3) (iv) and (v)
§ 1.274-5(c)(2)

Federal Rules of Civil Procedure 52(a)

The foregoing statutes, Treasury Regulations and Federal Rules of Civil Procedure are printed in App. C infra., pp. 51a to 57a incl.

STATEMENT OF THE CASE

For the years 1963-1967 inclusive, the Commissioner of Internal Revenue proposed deficiencies against Petitioner for corporate income taxes aggregating $100,000. These deficiencies were based upon disallowances of certain entertainment expenses incurred by Petitioner in entertaining executive officers and other employees of its longstanding major customers

at its hunting and fishing lodges located on Ocracoke Island, off the coast of North Carolina. Petitioner's business is that of manufacturing metal castings and forging, including the operation of a foundry for steel, brass and iron in Norfolk, Virginia where it also maintains its principal offices. Respondent concedes that Petitioner's Ocracoke facilities were used, "primarily for the furtherance of its business" and that the expenditures relating thereto were deductible as, "ordinary and necessary" business expenses under § 162 I.R.C. 1954; Respondent makes no claim that these facilities were used for personal reasons and there is no allegation that Petitioner abused the Internal Revenue laws. Respondent also concedes that Petitioner's books and records clearly reflect the elements of time, place, and amount but contends that Petitioner failed to prove "business purpose" and "business relationship." In this regard, Respondent relied upon *Dowell* v. *United States* 522 Fed.2d 708,716 (5th Cir., certiorari denied 425 U.S.920 (1976). A trial on the merits was held in October 1975, after which the United States Tax Court found that the major portion of Petitioner's entertainment activity and facility expenses were directly related to the active conduct of its business and were substantiated as required by § 274(a) and (d) I.R.C. 1954. The Tax Court rejected Respondent's contention that Petitioner's expenses were in the nature of good will (App. A, p. 19a).

At the trial, executives of Petitioner's major customers, such as Weyerhauser, Drill Carrier Corporation and Union Bag Camp, testified that on each occasion that they were guests at Petitioner's Ocracoke facilities, meaningful business discussions were held

with Petitioner's officers and sales representatives. The testimony of these witnesses was not contradicted by Respondent.

REASONS FOR GRANTING THE WRIT

Contrary to the findings of the United States Tax Court, the appellate court found that Petitioner had no more than "a general expectation of deriving some income or other specific trade or business benefit" other than good-will at some indefinite future time (App. B p. 41a). By substituting its findings for those of the trial court, the appellate court failed to abide by the instructions set forth in *Zenith Radio Corporation* v. *Hazeltine Research, Inc.* 395 U.S. 100, wherein, inter alia, this Court stated that, "The authority of an appellate court, when reviewing the findings of a Judge, as well as those of a jury, is circumscribed by the deference it must give to decisions of the trier of fact who is usually in a superior position to appraise and weigh the evidence"; continuing, this Court said, "The question in the Appeals Court under Rule 52(a) is not whether it would have made the findings the Trial Court did, but whether, on the entire evidence [it] is left with the definite firm conviction that a mistake has been committed", citing *U.S.* v. *United States Gypsum Company,* 333 U.S. 364, (1948). In its opinion, the United States Supreme Court referred to the decisions in *United States* v. *National Association of Real Estate Boards,* 339 U.S. 485, 495-496 (1950) and *Commissioner* v. *Duberstein,* 363 U.S. 278, 289-291 (1960). To the same effect, *Whipple* v. *C.I.R.,* 373 U.S. 193 at 203 (1963).

As trier of the facts, the U.S. Tax Court found that Petitioner had, by adequate records and other evi-

dence, satisfactorily substantiated the business purpose of the Ocracoke expenditures including the business relationship of its guests (App. A p. 27a). The appellate court, however, ignored these facts and found that Petitioner "failed to substantiate adequately the business purpose of the Ocracoke trips and the business relationship of its guests." (App. B p. 49a). As to this, the appellate court held that Petitioner was not entitled to these expenditures because it did not give the *names* of the employees of its customers although it acknowledged that the individuals were employees of Petitioner's customers. While § 274 I.R.C. does not require the *name* of the person in order to establish business relationship, Treasury Regulations § 1274-5(3) provides in pertinent part: "Entertainment in general." Elements to be proved with respect to an expenditure for entertainment are—

> (v) Business relationship. Occupation or other information relating to the person or persons entertained, including name, title, *or other designation, sufficient to establish business relationship to the taxpayer.* (Emphasis supplied)

By noting that, "Berkley's evidence consisted of undocumented recollections by witnesses whose memories were clouded by the passage of time . . ." (App. B p. 42a) the appellate court introduces an element not required by the Internal Revenue Code, nor those of the Treasury Regulations, namely, that of requiring *documentation* of business discussions (Emphasis supplied).

In holding that Petitioner's expenses were not directly related to the active conduct of its business,

the appellate court disregarded the instructions of this Court in *Kornhauser* v. *U.S.* 276 U.S. 145, 72 L.Ed. 505 48 S.C. 219 (1928); *Heininger* v. *Commissioner* 320 U.S. 467,470 (1943); *Bingham* v. *Commissioner* 325 U.S. 365 (1945) wherein it is stated that expenses must be, "directly connected with" or proximately resulting from the trade or business in order to qualify as "ordinary and necessary" business expenses. Having conceded that the expenses were "ordinary and necessary," the appellate court erroneously concluded that Petitioner's expenditures were not "directly related" to the active conduct of its business. Having qualified as, "ordinary and necessary" expenses they must, of necessity, have been directly related to the active conduct of Petitioner's business.

By virtue of inherent contradictions in its decision, including its refusal to abide by the "clearly erroneous" rule, and by disregarding this Court's criteria for determining the directly relatedness of an expenditure, the appellate court has compounded the confusion already existing as to "prolix and convoluted" regulations; they were so described by the United States Tax Court in Durgom, Vol. 43, T. C. Memorandum Decisions (Prentice-Hall ¶ 74,058).

Because of their complex nature, these regulations, create confusion often resulting in questionable assessments of income taxes. The well-publicized legislative purpose underlying the enactment of § 274 IRC 1954 was to prevent abuses in entertainment deductions. Toward this end Congress acted to prevent personal benefits under the guise of business entertainment. In the instant case, Petitioner's officers scrupulously avoided any personal benefit and Respondent makes no claim that the revenue laws were abused in this respect.

Once Respondent concedes that there has been no abuse of the Internal Revenue Code, it has discharged its duty in safeguarding the revenue. It should not be within its authority to propose tax deficiencies by way of regulations, the enforcement of which countermands Congressional intent. § 274 I.R.C. 1954 does not require a taxpayer to submit the names of persons who have been entertained as a rigid condition for complying with this provision. Approval of Respondent's actions in this regard is tantamount to upholding a tax by means of a regulation which, of course, the law does not permit. *United States* v. *Calamaro,* 354 U.S. 351, 359 [77 S.Ct. 1138, 1143 1 L.Ed2d 1394]; *Koshland* v. *Helvering,* 298 U.S. 441, 446-447 [56 S.Ct. 767, 769-770; 80 L.Ed. 1288]; *Manhattan (General Equipment) Co.* v. *Commissioner,* 297 U.S. 129, 134 [56 S.Ct. 397, 399, 80 L.Ed. 528]. Additionally, pending before the United States Tax Court are two cases involving the same issue, notwithstanding the fact that Petitioner made available to Respondent the *names* of the employees of Petitioner's corporate customers. The proposed additional assessments of income taxes in these pending cases, including accrued interest, exceeds $500,000.

In holding that Petitioner's, "corroborative evidence consisted of only nine of some 1,000 guests during the relevant years, their testimony related to only 12 of 76 trips" (App. B, p. 47a), the appellate court adopted Respondent's erroneous calculations, thereby reaching an obviously incorrect result. Specifically, on direct examination, the nine executives referred to by the appellate court, testified that, with few exceptions, they themselves were guests in each of the five years involved in this proceeding. (App. D pp. 582a-67a

incl.). On cross examination,Martin Ellers, Vice President, Drill Carrier Corporation, testified that he and other Drill Carrier employees were Petitioner's guests as many as 3 times in each of the five years. (App. E p. 68a). On cross examination, A. J. Scott, an American Oil Company official, one of Petitioner's customers, testified that he had been a guest at Ocracoke Island 12 or 15 times during the relevant five-year period. (App. E p. 68a). On cross examination, John Lee Wood, mechanical engineer for Drill Carrier Corporation, testified that he was a guest at least twice in some of the five years involved herein. (App. E p. 69a). On cross-examination Jerry Polk, Maintenance Superintendent for Weyerhaueser Company, testified that he was a guest more than once a year during 1964-1967 inclusive (App. E p. 69a). On cross examination, Richard H. Deal, project engineer for Albemarle Paper Company, testified that he had been Petitioner's guest several times. (App. E p. 69a). Each of these nine witnesses identified, by name, a total of 34 other employees of Petitioner's customers whom they recalled were Petitioner's guests while they were guests at Petitioner's facility. In concluding that there were 1,000 guests, the appellate court erroneously multiplied the same individual (guest) by the number of trips he made during the five-year period. By failing to make an independent review of the record, the appellate court departed from the accepted and usual course of judicial proceedings. By reason thereof, it reached an incorrect result in evaluating the testimony adduced at the trial. It is respectfully submitted that the appellate court could not, within the acceptable meaning of the rule, have had an independent, "definite and firm conviction that the Tax Court's decision was 'clearly erroneous.' "

In reversing the United States Tax Court, the appellate court, as did Respondent, relied upon *Dowell* v. *United States, supra* relative to the elements of "business purpose" and "business relationship." In the case at bar, Respondent concedes, and the appellate court concurs, that Petitioner satisfied the requirements as to amount, date, and place. The appellate court's reliance, however, upon *Dowell* as authority for holding that Petitioner failed to substantiate "business purpose" is misplaced. Specifically, the *Dowell* case holds that "business purpose" may be substantiated by trial testimony; the record in this proceeding is replete with such testimony.

Although the appellate court concluded, "that the claimed expenses, while undoubtedly business-related" —(App. B, p. 32a), it found, nonetheless, that they were not properly established on the evidence as *directly* related to the *active* conduct of its business. * * * (App. B, p. 41a). Having acknowledged that Petitioner's expenses were "business related," it follows that the element of "business purpose" has been substantiated as required by Treasury Regulation 1.274 5(b)(iv) (App. C, pp. 56a, 57a) and as interpreted by the 5th Cir. in *Dowell* v. *U.S.*, supra.

In *Dowell,* the 5th Circuit held that "business purpose" had been established even though names, dates, amount and place were not submitted. In view thereof, *Dowell* actually supports Petitioner as to the element of "business purpose"; consequently, the appellate court's holding on the issue of substantiation in this proceeding conflicts with that reached by the 5th Circuit in the *Dowell* case.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari in this case should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A

T. C. Memo. 1977-177

UNITED STATES TAX COURT

BERKLEY MACHINE WORKS & FOUNDRY COMPANY, INC., *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Docket Nos. 967-72 and 1248-73

Filed June 13, 1977

Petitioner owned and maintained three buildings on Ocracoke Island, North Carolina, which it used as hunting and fishing lodges, for the entertainment of employees of its major customers during 1963 through 1967. *Held,* the major portion of petitioner's entertainment activity and facility expenses were directly related to the active conduct of its business and substantiated as required by section 274(a) and (d), I.R.C. 1954. Petitioner is entitled, consequently, to deductions for depreciation and ordinary and necessary business expenses as determined. *Held further,* respondent erroneously disallowed an investment credit claimed by petitioner with respect to an airplane purchased by it in 1967. *Held further,* repair expense or capital nature of certain payments with respect to manufacturing equipment used at petitioner's plant determined.

Ellsworth T. Simpson, for the petitioner.

Nancy Mattox McMurrer, for the respondent.

Memorandum Findings of Fact and Opinion

BRUCE, *Judge*: Respondent determined deficiencies in petitioner's Federal corporate income taxes as follows:

Docket No.	Year	Deficiency
1248-73	1963	$16,849.45
	1964	22,193.27
967-72	1965	48,339.78
	1966	63,518.31
	1967	62,956.39

The cases have been consolidated for trial, briefing, and opinion pursuant to a joint motion of the parties. Each party has made certain concessions regarding the deficiencies that we are to redetermine. The following issues remain for our resolution:

(1) Whether certain deductions claimed by petitioner in connection with an entertainment facility maintained and activities conducted at Ocracoke Island, North Carolina, are allowable as ordinary and necessary business expenses in 1963 through 1967, inclusive;

(2) Whether petitioner is entitled to an investment credit with respect to an airplane purchased by it in 1967;

(3) Whether certain payments made by petitioner in connection with its equipment in 1965 and 1966 constitute currently deductible repairs expenses or capital expenditures subject to an allowance for depreciation.

Findings of Fact

Some of the facts have been stipulated by the parties and they are so found. Unless otherwise noted the following facts are of general applicability to all the years involved in this proceeding.

The petitioner, Berkley Machine Works & Foundry Company, Inc., was incorporated in 1914 under the laws of the Commonwealth of Virginia. It maintains its principal offices in Norfolk, Virginia, where its plant is also located. Petitioner timely filed its corporate income tax returns for the calendar years 1963 through 1967, utilizing the accrual method of accounting, with the district director of internal revenue at Richmond, Virginia.

Samuel G. Jones, Sr., has been petitioner's president since 1919, and during 1963 through 1967 he owned 83 percent of its capital stock. During the relevant years, Samuel G. Jones, Jr., was petitioner's vice-president and he owned the remaining 17 percent of its capital stock.

Petitioner's business involved the operation of a foundry for iron, steel, brass, and aluminum, including a pattern shop and a machine shop, and the manufacture of metal castings and forgings. Berkley manufactured both parts which other companies used in their production of a finished product and repair parts for equipment used by for parts that petitioner manufactured were provided other companies in their production process. Patterns for parts that petitioner manufactured were provided either by existing plans and specifications or by using old parts as a sample. Petitioner's ability to acquire a particular job of manufacturing equipment repair parts was often dependent upon its ability to produce them more quickly and less expensively than the original equipment manufacturer.

Because of the nature of petitioner's business, media advertising was of limited usefulness. The company's policy for promoting sales was that of developing and maintaining personal contact with the appropriate personnel of its customers—individuals often in various departments of the same company. Berkley's principal sales efforts were directed toward a small number of major customers, identified by name on the following chart depicting petitioner's sales:

TABLE 1

BERKLEY MACHINE WORKS & FOUNDRY CO., INC.
SALES ANALYSIS

CUSTOMER	1963	1964	1965	1966	1967
Albemarle Paper Company	$ 57.60	$ 2,289.25	$ 7,465.34	$ 21,135.77	$ 18,650.93
American Oil Company	3,959.30	9,600.47	25,097.03	49,230.52	50,034.20
Atkinson Dredging Company	29,253.82	21,787.14	10,323.40	22,028.40	9,589.55
Bowen-McLaughlin-York	290,679.39	5,249.89	82,557.18	174,073.31	329,481.30
Drill Carrier Corporation	669,098.21	931,574.18	845,669.38	841,019.94	749,561.37
Franklin Equipment Company ...		65,059.80	250,764.24	356,205.65	258,701.31
Pennsylvania RR (Penn Central).	74,223.87	67,973.22	128,164.62	171,991.36	139,839.21
Texas Gulf Sulphur Company ...					11,075.40
Union Bag-Camp Corporation ...	12,081.83	39,247.42	24,949.27	30,575.06	27,989.64
Weyerhaeuser Corporation	6,050.00	27,408.98	13,058.36	33,706.43	103,233.17
All Other Customers ..... (Approximately 150)	397,684.47	305,051.75	340,002.12	289,787.62	294,523.15
TOTALS	$1,513,088.49	$1,475,242.10	$1,728,050.94	$1,989,754,06	$1,992,679.23

Petitioner's contact with these customers, the frequency of which varied from as often as three or four times a day to as seldom as once a week, was maintained primarily through two sales representatives. E. M. Weber concentrated his activities in the area around York, Pennsylvania, where Pennsylvania Railroad and Bowen-McLaughlin-York were located. From the Norfolk office, C. M. Halsey directed the sales effort toward local customers and customers located in other southeastern states. However, petitioner's largest customer, Drill Carrier Corporation, was serviced by Samuel G. Jones, Jr., and F. P. Huber, the foundry superintendent.[1]

One of the means by which petitioner cemented its relationship with its customers was by use of an entertainment facility owned and maintained by it on Ocracoke Island. Ocracoke is an island off the Atlantic Coast of North Carolina, just south of Hatteras. It is an isolated island consisting of a small cluster of homes at one end and a succession of sand dunes and marshes leading to the other end. There is no bridge leading from the mainland to the island, a ferry being the only means of public transportation to Ocracoke.

Petitioner's Ocracoke facility consisted of three buildings of wood frame construction, the exteriors of which were covered with fir shingles. Each building was designed as a home, with a living room, a dining room, and several bedrooms. The interiors were nicely furnished to reflect the tastes of Jones, Sr. On the second floor of Berkley Castle, the largest of the three buildings, was a conference room containing a drafting board, a large table, and a number of chairs. Known as Berkley Castle, Berkley

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[1] Subsequent to the years at issue in this proceeding, Drill Carrier Corporation was purchased by the Gardner-Denver Corporation. Prior to the merger, Gardner-Denver was the primary marketing force for Drill Carrier's product.

Manor, and Berkley Ranch House, the three buildings were used as hunting and fishing lodges.

During 1963 through 1967, employees from all of petitioner's major customers (except Texas Gulf Sulphur) and from a few of its smaller customers were invited by petitioner's officers and sales representatives to visit the Ocracoke facility for hunting and/or fishing trips. On occasion petitioner's business associates would be accompanied by members of their families, or other guests having no direct business relationship with petitioner. The number of guests present at a single time varied between about 6 and 30, the general number approaching the arithmetical mean of these extremes. Guests typically received, as mementos of their Ocracoke visit, gifts distributed by petitioner such as hunting and fishing knives, model ducks to be used as doorstops, cookbooks or other books, and neckties with a Berkley label.

Petitioner's Ocracoke facility was used throughout the year, but primarily on weekends from late spring through early fall. However, guests were not invited each and every week even during this period. A typical fishing trip to Ocracoke began on Thursday afternoon or Friday morning. After breakfast on Friday, the fishermen split into teams of four, five, or six and fished until lunchtime from boats chartered by petitioner from various individuals who were engaged in the business of taking out fishing parties off the coast of North Carolina. The fishermen returned to Berkley's facility for lunch, and then resumed fishing for the remainder of the afternoon. Saturday's activities duplicated those of Friday. Guests generally left the island after breakfast on Sunday.

The Ocracoke setting established a congenial and relaxing atmosphere in which petitioner's sales representatives pursued petitioner's business interests, i.e. promoting sales. Business discussions often centered around specific jobs that Berkley was in the process of performing for its

customer-guests. At other times determinations were made whether Berkley could perform specific jobs which the customer-guests needed done. On occasion petitioner's guests would initiate discussions about problems that arose only a few days prior to their trip to Ocracoke, after the visit had been plannd. The conference room in Berkley Castle was used when examination of plans and specifications was pertinent. Discussions of anticipated business needs and job scheduling were conducted in even less formal surroundings, *e.g.* on the fishing boats, during meals, and while relaxing after dinner.

In composing the parties to be invited to Ocracoke on a particular occasion, Berkley's representatives sometimes included employees from several different customer-companies. By so mixing its guests, petitioner was able to make certain customers aware of the work that it was performing for others—the underlying purpose of which was to inform each company of the different and additional types of work that petitioner could do for it.

Business guests visiting Ocracoke believed the trips there to be meaningful and beneficial to both their employers and to Berkley because of the actual substantive matters discussed and resolved and also because of the information they received about various other functions that Berkley could perform for them.

In addition to Berkley's Ocracoke facility, petitioner's president and major stockholder, Samuel G. Jones, Sr., owned and maintained a vacation home elsewhere on the island. Although it was usual for Jones, Sr., to attend the Berkley facility while guests were being entertained, he did not participate in the hunting or fishing and he returned to his personal residence in the evenings.[2] Peti-

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[2] Mrs. Jones, Sr., visited the personal residence for only three or four weeks each summer, and she was apparently not connected in any manner with Berkley's entertainment activities on the

tioner's Ocracoke facility was not used by Jones, Sr., members of his family or other Berkley employees for entertainment unrelated to the advancement of Berkley's business. Respondent has conceded that the Ocracoke facility was used primarily for the furtherance of petitioner's trade or business.

Petitioner employed a caretaker to oversee the operation of its Ocracoke facility. The caretaker was responsible for preparation of the facility for use by petitioner's representatives and guests, which, when appropriate, included chartering the required number of fishing boats. Other islanders were hired to do cleaning, laundering, and the cooking and serving of meals at the facility. The caretaker collected bills for the various expenses incurred on the island, *e.g.* boat charter fees, restaurant meals, and groceries, and forwarded them to petitioner's Norfolk office for payment.

Most of the expenditures in connection with petitioner's Ocracoke facility and entertainment activities (other than payroll and capital expenditures) were charged to two expense accounts: promotional sales and Berkley Manor supplies.[3] The cash receipts and disbursements journals and general expense ledgers in which these accounts were maintained were kept in the regular course of petitioner's business and conformed to generally accepted accounting principles. In addition to the corporate books, which contain the data of each expenditure, petitioner retained the complementary invoices, receipts, and petty cash vouchers and reimbursement sheets which support the book entries

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island. No contention has been advanced by respondent that any expenses related to the personal residence are included in the amounts at issue herein.

[3] The promotional sales account was not used exclusively to record expenditures related to Ocracoke, and this fact gives rise to the first matter discussed under the Opinion heading *infra*. "Berkley Manor Supplies" was a code name used by petitioner to refer to its entire Ocracoke facility.

for these accounts. Many of the cash journal entries and related documents contain a notation of the Ocracoke guests to whom the expenditures relate. Other documents, supporting expenditures for quantities of items to be used over the course of several Ocracoke visits, do not contain the names of particular guests.

The total amounts disallowed by respondent and remaining in dispute in connection with petitioner's entertainment activities and facility at Ocracoke are set forth below in Table 2:

TABLE 2

	1963	1964
Expenditures	$ 7,389.01	$ 4,133.29
Depreciation	23,096.60	30,469.58
	$30,485.61	$34,602,87

	1965	1966	1967
"Promotional Sales," "Supplies"	$ 10,164.88	21,967.66	24,738.20
Miscellaneous	795.97	915.02	2,230.20
Gas & Oil	205.26		
Utilities	533.00	117.43	
Repairs	1,334.85	8,109.69	9,758.07
Payroll	14,559.80	30,248.01	24,687.40
N.C. Unemployment Tax (Ocracoke)	525.69	1,972.17	1,316.21
FICA Tax	515.03	1,130.52	979.76
Employee Benefits			294.80
Insurance	884.00	1,569.56	943.00
Airplane Expense		5,762.05	
Loss on Boat Sale			7,440.17
Depreciation	30,151.18	34,681.76	45,230.37
	$ 59,669.66	$106,473.87	$117,618.18
Employee meeting[4]			(1,666.49)
	$ 59,669.66	$106,473.87	$115,951.69

[4] This reduction represents a proportionate part of the Ocracoke expenses allowed by respondent in the notice of deficiencies due to an employee meeting held at the facility in 1967.

Neither the amounts of the expenditures nor the cost bases, useful lives, and salvage values assigned by petitioner to the assets on which depreciation was claimed are in dispute.

Inasmuch as petitioner maintained no separate diary or account book relating exclusively to its Ocracoke entertainment, the documented information pertinent to this litigation has had to be gathered piecemeal from the corporate books and supporting data. These show that petitioner's Ocracoke facility was used on the following number of occasions during the years in issue:

TABLE 3

Year	Times Used
1963	13
1964	9
1965	17
1966	18
1967	19

With the exception of one use in each of the years 1963, 1965, 1966, and 1967, to be discussed below, each use involved entertainment of employees of petitioner's customers of the type heretofore described.[5]

In 1963 at the request of the Ocracoke Civic Club (an island organization similar to a chamber of commerce), petitioner allowed one of the club members and two representatives of the Interior Department of the Federal government to stay at its Ocracoke facility. The individuals were examining the possibility of increased ferry service to Ocracoke and the possible establishment of an airport on the island.

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[5] The entry on Table 3 for 1967 includes the Berkley employees' meeting held at the Ocracoke facility, an additional variation from the general use of the facility. Respondent has conceded however, that the expenses connected with this use of the facility are allowable as deductions. See note 4, *supra*.

In 1965 petitioner hosted a party for a local public figure, Lindsay Warren, at its Ocracoke facility.

In 1966 petitioner allowed one of its customers, Union Camp Corporation, to hold an internal sales meeting at its Ocracoke facility. Although Jones, Sr., and Halsey sat in on the meeting, this use differed in character from the regularly conducted entertainment activities at Ocracoke.

In 1967 petitioner entertained some North Carolina legislators at the same time representatives of Atkinson Dredging Company attended its Ocracoke facility.

Berkley's expenditures directly connected with these four uses of its Ocracoke facility are set out in the following table:

TABLE 4

Year	Entertainee	Amount	Check Number
1963	Beasley	$ 50.00	34051
		85.00	34183
1965	Warren	80.00	40507
		60.40	40523
		15.00	40538
1966	Union Camp	25.53	43180
	(internal sales meeting)	18.63	43179
		10.00	43092
		191.61	43091
		179.20	43223
1967	N.C. legislators &	294.33	47508
	Atkinson Dredging Co.	18.54	47446
		18.20	47468
		90.00	47506
		27.63	47512
		4.84	47511
		36.00	47438
		5.01	47613
		30.00	47496

Although the business motivation for each of these uses is apparent, petitioner has failed to demonstrate that the expenses attributable thereto were incurred in the active conduct of its business.

The entries in Table 5 below represent amounts that respondent argues on brief were not ordinary and necessary business expenses:

TABLE 5

Year	Amount
1963	$ 529.53
1964	371.00
1965	356.66
1966	5,710.33
1967	2,434.74

These expenses relate to sundry items recorded in petitioner's promotional sales and Berkley Manor supplies accounts, but in large part to expenditures for photographic services and supplies, waitress costumes, the Beasley and Warren visits in 1963 and 1965, respectively, and gifts distributed at Ocracoke. The expenditures for gifts are further set forth in the following table:

TABLE 6

Year	Amount	Check Number
1963	$ 49.50	33025
1965	105.85	40407
1966	92.87	42597
	255.60	44100
	1,954.50	"
	49.05	43550
1967	8.00	46806
	10.00	47095
	40.00	47580
	50.00	47356
	289.32	48512
	20.00	47510
	153.84	47679

The entries in Table 7 below represent amounts recorded in petitioner's promotional sales accounts which petitioner maintains were unrelated to its Ocracoke entertainment and, consequently, erroneously disallowed by respondent:

TABLE 7

Year	Amount
1963	$287.64
1967	23.23

With the exception of a $9.06 expenditure for photographic supplies in 1963, the amounts contained in Tables 5 and 7 relate to different expenditures. The remaining expenditures represented by the 1963 entry were for items, largely foodstuffs, of the type generally used at Ocracoke. The 1967 entry represents the cost of a restaurant meal for the Ocracoke caretaker and eight other Ocracoke employees.

Included in the total depreciation disallowed by respondent for 1967 is $1,441.46 claimed by petitioner with respect to an airplane purchased by it at a cost of $86,487.90 in that year. Also disallowed was an investment credit of $6,054.14 claimed by petitioner with respect to the airplane. Both items were disallowed based on respondent's determination that the airplane was purchased for use in connection with petitioner's Ocracoke entertainment activities.

Expenditures on Machinery

In 1965 petitioner incurred expenses of $7,906.88 in connection with a model 4-A Warner & Swasey turret lathe owned and operated by it at its Norfolk plant. A turret lathe is a high production piece of equipment used in the manufacture of metal parts to cut them within required tolerances. The machine in question was very large and in order to disassemble some of its components the use of

overhead cranes was necessary. The turret lathe was removed to the plant of Precision Rebuilding Corporation where that company performed the work necessary to return the machine to the accuracy required for Berkley's use. Included in the total expenditure, all of which was claimed by petitioner as an ordinary and necessary business expense, was $736.29 which represented the cost of a modification to permit the turret lathe to use tools that it could not use before.

Precision Rebuilding Corporation performed two different services for its customers: rebuilding of machines and maintenance of machines for smaller companies, like Berkley, which did not have their own maintenance crews. Rebuilding Berkley's turret lathe would have cost between $24,000 and $25,000. The service that was performed, however, with the exception of the $736.29 expenditure, merely kept Berkley's machine in efficient operating condition without adding to its value or appreciably prolonging its useful life.

In 1966 petitioner incurred expenses of $13,661.84 for parts in connection with a wheelabrator machine located at its Norfolk plant. A wheelabrator machine is used for the blast cleaning of castings after they have been shaken out of a mold. It operates by throwing steel shot or steel grit media at the castings from a wheel at high velocities. By the nature of the work it performs, a wheelabrator is a somewhat self-destructive machine and it requires the replacement of liners and various component parts to stay in efficient operating condition. The parts purchased by Berkley were such necessary parts. They did not materially increase the value of the machine or extend its useful life.

Also in 1966, petitioner incurred expenses of $6,826.00 with respect to a lectromelt furnace used in its Norfolk plant. A lectromelt furnace is an electric furnace used to melt steel from which castings are poured. An armature for the D.C. generator used in the melting processing cost

$726.00. The remainder of the expenditure, $6,100.00, was for a new furnace shell, the vessel in which steel is melted. A furnace shell is a separate unit of the larger furnace, itself made up of component parts. The new furnace shell replaced one that had been in use for about 20 years.

Opinion

During 1963 through 1967, petitioner owned and maintained three buildings on Ocracoke Island, North Carolina, where it regularly entertained employees of its major customer companies. Petitioner incurred substantial expenses in connection with it Ocracoke entertainment and claimed deductions therefor as depreciation and ordinary and necessary business expenses. In his statutory notices of deficiencies, respondent disallowed "in accordance with section 274 of the Internal Revenue Code" [6] deductions for the sums he determined to be "Ocracoke expenditures."

The primary issue in this case is whether petitioner's Ocracoke-related entertainment expenses are deductible under the provisions of section 274. With certain exceptions, we hold for petitioner. Before proceeding to a discussion of section 274 and the bulk of the expenditures at issue, however, we think it appropriate to resolve the proper categorization of the expenses represented on Tables 5 and 7.

Table 7 represents a portion of the total amounts disallowed by respondent as "Ocracoke expenditures" which petitioner maintains were deductible expenditures unrelated to its Ocracoke entertainment.[7] The 1963 expenditures at issue here were for items, largely foodstuffs, of the type

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[6] All statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue.

[7] Petitioner claimed at trial that additional expenditures originally disallowed were non-Ocracoke related, but with the exception of those on Table 7, respondent has so conceded.

generally used at Ocracoke, however, and petitioner has offered no explanation of why it considers them non-Ocracoke related. We think they must be considered Ocracoke expenditures. The only other entry on Table 7, $23.23 in 1967, represents the cost of a restaurant meal for the Ocracoke caretaker and eight other Ocracoke employees. This expenditure is properly considered apart from the other Ocracoke expenditures, but at least in view of our ultimate conclusion about the nature of petitioner's Ocracoke entertainment, its deductibility is sanctioned by sectioned 274(e)(5) and section 1.274-2(f)(2)(v), Income Tax Regs., relating to expenses for employees.[8]

Respondent, meanwhile, has mounted a multi-faceted attack on the expenditures represented by Table 5. Phrasing his argument generally in the terminology of section 162, respondent argues that petitioner failed to show how the expenditures represented by Table 5 related to the entertainment of its customer-guests at Ocracoke. While respondent may be technically correct, in that no one testified specifically as to the purpose of these expenditures, each of them is included in petitioner's records introduced at trial and identified by petitioner's head bookkeeper and office manager to be Ocracoke expenditures. Furthermore, it requires no stretching of the imagination to relate photography with hunting and fishing trips or waitress costumes with waitresses serving meals in the Ocracoke facility dining room.

Most important in this regard, however, is respondent's failure to designate prior to trial which expenses he thought not ordinary and necessary. The notices of deficiencies stated that "Ocracoke expenditures" were being disallowed "in accordance with section 274." Section 274

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[8] As indicated by our prior notation of the virtual lack of mutuality between the expenditures represented by Tables 5 and 7, respondent does not argue that this expenditure was not an ordinary and necessary business expense.

being strictly a disallowance provision, before its terms became applicable, a deduction must be allowable under some other provision of the Code. *Sanford* v. *Commissioner*, 50 T.C. 823, 826 (1968), affd. per curiam 412 F. 2d 201 (2 Cir., 1969), certiorari denied 396 U.S. 841 (1969). See section 1.274-1, Income Tax Regs. Respondent did suggest in his trial memorandum that some of the expenses involved might not meet the requirements of section 162, but it was not until his initial brief was filed that he designated which expenses he had in mind. As a comparison of the totals from Table 2 and Table 5 reveals, particularly in light of the Table 5 expenses which must be disallowed on other grounds, the expenses now challenged on the basis of section 162 make up a rather small portion of the total expenditures in issue. As a practical matter neither the Court nor, we are sure, either of the parties would want an already burdensome record to be further burdened with questions and answers with respect to each expenditure if its business nature was not in dispute.[9] Under the circumstances we think the record supports the allowability of the Table 5 expenses as ordinary and necessary business expenses.[10]

Although we reject respondent's section 162 argument, we nevertheless sustain his determination that deductions for the expenditures represented on Table 6 must be disallowed. In his notices of deficiencies, respondent allowed petitioner deductions each year for business gifts in the lesser of the amount claimed or $2,500.00. Table 6 contains the costs of various gifts distributed at Ocracoke which petitioner has not shown satisfy the restrictions of sections

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[9] Cf. *Lickert* v. *Commissioner*, T.C. Memo 1964-47.

[10] Lest it not be clear, respondent's argument is based upon petitioner's failure to prove the relationship between these expenses and entertainment of its customers. Had respondent seen his way clear to develop the record with affirmative evidence, his argument might well stand in a different light.

274(b)[11] and (d), and the regulations promulgated thereunder.

We come now to consideration of section 274 and deductibility of the expenses incurred by petitioner in connection with its Ocracoke facility and entertainment activities. With the enactment of section 274, effective as of January 1, 1963, Congress narrowed the class of entertainment expenses theretofore deductible under other provisions of the Code and established strict substantiation requirements with respect to entertainment expenses. Both parties have submitted lengthy briefs cataloging the development of section 274, and yet the substantive issue, as it has developed in this case, is largely a factual one.[12]

Respondent concedes that petitioner's Ocracoke facility was used primarily for the furtherance of petitioner's business but argues strenuously that neither the activity nor facility expenditures were directly related to the active

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"Section 274(b) provides in pertinent part as follow:

SEC. 274. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES.

* * * * * * * * * * *

(b) Gifts.—

(1) Limitation.—No deduction shall be allowed under section 162 or section 212 for any expense for gifts made directly or indirectly to any individual to the extent that such expense, when added to prior expenses of the taxpayer for gifts made to such individual during the same taxable year, exceeds $25. * * *

See footnote 16, *infra*, for the text of Section 274(d).

[12] The Congressional purpose and legislative history of section 274 have been examined in depth elsewhere, and we see no need to reiterate them here. See, *e.g.*, *Dowell* v. *United States*, 522 F. 2d 708 (5th Cir. 1975), certiorari denied 426 U.S. 920 (1976); *Hippodrome Oldsmobile, Inc.* v. *United States*, 474 F. 2d 959 (6 Cir. 1973); *St. Petersburg Bank & Trust Co.* v. *United States*, 362 F. Supp. 674 (M.D. Fla., 1973), affd. 503 F. 2d 1402 (5 Cir. 1974), certiorari denied 423 U.S. 834 (1975).

conduct of its business within the meaning of section 274 (a)(1).[13] Although finding it "strange if business had not been a topic of conversation," respondent would have us characterize the Ocracoke visits as goodwill-oriented pleasure trips with business discussions arising only as a by-product of bringing a group of businessmen together. The record, however, does not support such an interpretation with respect to the regularly conducted entertainment of petitioner's customer-guests. Rather, it clearly establishes that substantial and bona fide business discussions directed toward generation of income for petitioner arising from transactions stemming therefrom were both the reason for and result of these Ocracoke visits.

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[13] SEC. 274. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES.

(a) Entertainment, Amusement, or Recreation.—

(1) In General.—No deduction otherwise allowable under this chapter shall be allowed for any item—

(A) Activity.—with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with, the active conduct of the taxpayer's trade or business, or

(B) Facility.—With respect to a facility used in connection with an activity referred to in subparagraph (A), unless the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of such trade or business, and such deduction shall in no event exceed the portion of such item directly related to, or, in the case of an item described in subparagraph (A) directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), the portion of such item associated with the active conduct of the taxpayer's trade or business.

Petitioner's business of manufacturing machinery parts for other companies did not lend itself to media marketing but required personal contact between petitioner's sales representatives and employees of the companies to which petitioner sold its products. Petitioner had an ongoing business relationship with each of the customers it regularly invited to hunting and fishing trips at Ocracoke. The Ocracoke setting provided a congenial and relaxing atmosphere in which petitioner's sales representatives had several days of constant exposure to the individuals with whom they did business and with whom they were able to conduct the same types of business as when calling upon them at their offices. The record is replete with examples of specific projects that were the subject of business discussions held at Ocracoke. At times guests brought plans and specifications for jobs to be discussed over the course of an Ocracoke visit. By mixing the guests from several customers, petitioner was able to stimulate sales by making some companies aware of the work that it performed for others—within the context of specific examples.

Respondent seeks to impugn the principal business character of all of petitioner's Ocracoke entertainment by emphasizing the four uses of the facility identified on Table 4 and isolated bits of ambiguous testimony. The proper disposition with respect to the Table 4 uses, however, is disallowance of deductions for the expenses incurred in connection with these uses [14] and for the appropriate fractional portion of the facility's total operational expenses. Section 274(a)(1). Nor do we think that the testimony of John William Gladstone, for example, justifies respondent's characterization of the Ocracoke entertainment. Gladstone was a technical service superintendent for Albemarle

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[14] Petitioner's records do not permit an allocation of expenditures between Atkinson Dredging Co. and the North Carolina legislators with respect to their joint use of the facility in 1967. Consequently, the total expenditures as set forth in Table 4 must be disallowed. Cf. sec. 1.274-5(c)(6)(ii), Income Tax Regs.

Paper Company, whose responsibilities were product quality control and customer services. Albemarle used Berkley products. Testifying in 1975, Gladstone indicated that he visited petitioner's Ocracoke facility on two occasions "about ten or twelve years ago," that he did not have *direct* contact with petitioner in the normal course of business, and although he realized that he was invited to Ocracoke because of his business position, that his primary purpose in going was to enjoy himself. Table 1 shows that in the period that Gladstone visited Ocracoke, petitioner was just beginning to develop Albemarle as a customer. We do not think it unreasonable that petitioner might expect an individual in Gladstone's position to be one with whom it would deal in attempting to sell its products. We find it much more significant that Gladstone was not invited back to Ocracoke in later years, alhough other Albemarle employees visited there even after the taxable years here in issue. Moreover, Gladstone's testimony indicates that he was included in business discussions during the visits that he made. That petitioner may have misjudged at the outset of its relationship with Albemarle the extent to which Gladstone would be involved does not alter our conclusions about petitioner's expectations and active pursuit of business during its Ocracoke entertainment. Likewise, the occasional presence of family members of petitioner's business guests does little to detract from the strong showing of substantive business purpose of petitioner's Ocracoke entertainment.

Respondent's reliance upon *Handelman* v. *Commissioner*, 509 F. 2d 1067 (2 Cir. 1975), and *Hippodrome Oldsmobile, Inc.* v. *Unitted States*, 474 F. 2d 959 (6 Cir. 1973), is misplaced. *Handelman* involved expenses in connection with a sailing sloop on which the taxpayer claimed to entertain clients and potential clients in his law practice. The principal holding there was that the taxpayer failed to establish that the facility was used primarily for business purposes—an issue conceded here by respondent. The court

went on, however, "to conclude from this record that the taxpayer scrupulously avoided any encroachment on the glamorous atmosphere he wished to create so that he did not conduct any business on the boat." The record in this case establishes, to the contrary, that petitioner's customer-guests often brought problems for discussion at Ocracoke that had arisen after a trip was planned—complete refutation that business was an encroachment upon the atmosphere generated in the Ocracoke setting.

The fact that entertainees initiated some of the specific discussions does not bring this case within the ambit of *Hippodrome Oldsmobile, Inc.*, however. In that case the court of appeals held on the basis of a factual finding that the taxpayer's representative "would not initiate business conversation" that entertainment expenses incurred under such circumstances were not "*directly* related to * * * the *active* conduct of the taxpayer's * * * business." This case does not involve such a factual finding.

We do not doubt, as respondent argues, that petitioner engendered the goodwill of its customers by maintenance and use of its Ocracoke facility. Nevertheless, we are convinced that the principal character of the combined entertainment and business trips to Ocracoke was the active conduct of petitioner's business, to wit, to discuss business problems and needs of its major customers and inform them of the variety of functions that petitioner could perform within the context of specific jobs being done for others. Consequently, deductions for the expenses attributable to these uses are allowable under section 274(a)(1) and sections 1.274-2(c)(3) and 1.274-2(d)(4), Income Tax Regs.[15]

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[15] Because we hold for petitioner on the substantive issue on the basis of the directly related in general test described in sec. 1.274-2 (c)(3), Income Tax Regs., we do not elaborate on its questionable but logically appealing argument that many of the expenditures come within the business meal exception of section 274(e)(1) and

The basic substantive issue having been resolved, we must now consider whether petitioner has satisfied the rigorous substantiation requirements of section 274(d)[16] for the expenditures incurred in the active conduct of its business. Pursuant to section 274(d), a taxpayer must establish five elements with respect to each entertainment expenditure—amount, time, place, business purpose, and business relationship. See sections 1.274-5(b)(3) and 1.274-5(c), Income Tax Regs.

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the corresponding regulations or its argument that Ocracoke constituted a clear business setting within the meaning of sec. 1.274-2 (c)(4), Income Tax Regs. Nevertheless we have considered these arguments sufficiently to determine that their applicability would not alter the result we reach with respect to the expenditures on which respondent's determination is sustained.

[16] SEC. 274. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES.

* * * * * * * * * * * *

(d) Substantiation Required.—No deduction shall be allowed—

(1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),

(2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, or

(3) for any expense for gifts, unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility, or receiving the gift. The Secretary or his delegate may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations.

Petitioner did not maintain a separate diary or account book for its Ocracoke expenditures; rather, they were recorded in its cash journals and general expense ledgers together with other business expenses. Petitioner did retain, however, invoices, receipts, and petty cash records which document each of the disputed expenditures recorded in its promotional sales and Berkley Manor supplies accounts. The petty cash records consisted of typed summaries of disbursements, made periodically as the account was replenished, and the appropriate supporting documents for those disbursements. The corporate books document all of the expenses involved herein. Respondent does not dispute the cost bases, useful lives, and salvage values assigned by petitioner to the assets on which depreciation was claimed, and he agrees that the amounts of expenditures are substantiated and that the place of entertainment was Ocracoke.

Respondent also agrees that the time of each expenditure has been established, but he contends that the date of payment is insufficient to meet the requirement of section 1.274-5(b)(3)(ii), Income Tax Regs., which refers to "Date of entertainment." Respondent argues that because of the time lag between when entertainment occurred and when bills were forwarded to and paid from petitioner's Norfolk office, it is impossible to reconstruct the dates of trips without resorting to precisely the type of approximation that Congress intended to invalidate with the enactment of section 274(d). Respondent's reasoning may be correct, but it is based on an erroneous or inadequate view of the evidence. Contained in the data supporting the cash journal entries are numerous restaurant tickets which reflect dates that meals were taken. These tickets establish with specificity when guests were on the island. Some of the petty cash vouchers also reflect specific dates of the trips to which the reimbursed expenditures relate. Starting with the specific dates established by these documents, the other bills, invoices, and receipts can be related to parti-

cular dates of entertainment. This type of reconstruction is exactly what has led to our entries on Tables 3 and 4, and it establishes an accurate portrayal of the use of the Ocracoke facility.[17]

Disagreement over substantiation of the business relationship element revolves around respondent's contention that the *name of each individual* entertained at Ocracoke must be identified and related to a particular visit and specific expenditures in order to satisfy the statutory requirement. Although many of the individual guests were identified at trial, petitioner's records permit only a determination of which companies' employees were present at Ocracoke on a particular occasion. If respondent's position is correct, petitioner has failed to substantiate its business relationship with its Ocracoke entertainees for any use of the facility.

Respondent cites as authority for his view the following language from *Dowell* v. *United States,* 522 F. 2d 708, 716 (5 Cir., 1975), certiorari denied 426 U.S. 920 (1976):

> The substantiation statute says "the"—not "a" business relationship. And the business relationship cannot be ascertained unless the taxpayer establishes the

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[17] In fairness to respondent, we should note that petitioner also failed to emphasize with precision the evidence by which the dates of entertainment are established. The chart appended to its initial brief was deficient in several respects and properly criticized by respondent. We think, however, that respondent has taken an entirely too critical view of petitioner's records as a whole. In his criticism respondent ignores, for example, that each of the facility uses set out in Table 4 is revealed in petitioner's records; those uses were not uncovered solely by third-party information, a factor which might tend to render suspect all of the entertainment expenses. We recognize that record-keeping in good form would do much toward eliminating this kind of litigation, and petitioner's records were not in good form, but we cannot and should not ignore the substance of the evidence placed before us.

> identity of his entertainee—whether by name, title, or other specific designation.

Although we think the plain language of the excerpt refutes respondent's contention, when placed in context it is clear that his interpretation is erroneous. The quoted language was written in reference to expenses that were not related to any particular entertainee. It is part of a discussion by the court of monthly statements introduced by the taxpayer without itemization of persons entertained, dates of entertainment, amounts of particular expenditures, and in some instances even the place of entertainment. The court was discussing the business relationship element in contradistinction to a showing of the business purpose of the expenditures. The district court's finding of business purpose was upheld by the court of appeals, but it wished to make clear that establishing the business purpose element of substantiation is not tantamount to establishment of the business relationship element—even concededly business related entertainment expenses must be connected with *some* particular entertainee, whether by name, title, or other specific designation, in order to satisfy the requirement of section 274(d).

Similar analysis disposes of respondent's reliance upon *Bradley* v. *Commissioner*, 57 T.C. 1, 9 (1971). There, again, one defect in the taxpayer's evidence was his failure, with one exception, to relate particular expenditures to ***any*** person or persons entertained.

We cannot read either of those cases, or the language of section 1.274-5(b)(3)(v), Income Tax Regs., to make the names of individuals a mandatory requirement in establishing business relationship. That it is the substance of the relationship and not the particular form of recordkeeping that substantiates business relationship, when expenditures are connected with some entertainee, was made clear by our recent decision in *Rutz* v. *Commissioner*, 66

T.C. 879, 885 (1976). In *Rutz* we found contemporaneously maintained records that contained only the names of individuals who were guests of the taxpayer inadequate to substantiate business relationship.

In this case respondent does not dispute that petitioner derived substantial income from the companies which employed the individuals entertained at Ocracoke (See Table 1). Petitioner's records show the companies whose employees visited Ocracoke on particular occasions, and most of the expenditures can be related to particular uses of the facility. With respect to those expenses not capable of being connected with a particular use of the facility, e.g. foodstuffs placed in storage for use during several entertainment periods, we think this a proper situation for application of section 1.275-5(c)(4), Income Tax Regs., relating to substantiation in exceptional circumstances where the taxpayer has presented the best evidence possible. In short, petitioner has substantiated its business relationship with the guests, and persons closely connected to them, employed by the companies with whom it did business. See *Nicholls, North, Buse Co.* v. *Commissioner*, 56 T.C. 1225, 1235-1236 (1971).

The business purpose of petitioner's Ocracoke entertainment has likewise been established. Both petitioner's employees and its business guests testified regarding the nature of the business activity conducted at Ocracoke. Contrary to respondent's characterization of their testimony as vague and general, it provided in detail some of the specific jobs or projects discussed during certain visits to the island. Indeed, this evidence formed the basis for our finding the Ocracoke expenditures incurred were directly related to the active conduct of petitioner's business. Again we emphasize the ongoing business relationship between petitioner and the company-employers of its business guests, because that relationship set the tone for both the business benefits petitioner expected to derive from

its Ocracoke expenditures and the nature of the business discussions engaged in there. The record does much more than establish that petitioner's guests were merely connected in some way with the companies with which petitioner did business. See *Nicholls, North, Buse Co.* v. *Commissioner, supra,* at 1236. Also significant is the total absence of evidence of personal friendships between petitioner's stockholder-employees and its business entertainees —a factor that has led this Court on many prior occasions to seriously question the purported business purpose of entertainment expenditures. See, e.g., *Rutz* v. *Commissioner, supra,* at 886; *Sanford* v. *Commissioner, supra,* at 826-827.

During the taxable year 1967, petitioner purchased an airplane at a cost of $86,487.90. On its income tax return for that year, petitioner claimed an investment credit in the amount of $6,054.14. Respondent disallowed both the investment credit and the depreciation deduction claimed with respect to the airplane based on his determination that the airplane was to be used in connection with petitioner's Ocracoke entertainment.

Sections 38, 46, and 48 allow a credit against income tax for depreciable personal property placed in service during the taxable year. Section 1.46-3(d)(1), Income Tax Regs., provides that property will be considered as placed in service the earlier of:

> (i) The taxable year in which, under the taxpayer's depreciation practice, the period for depreciation with respect to such property begins; and
>
> (ii) the taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity.

In view of our finding that the Ocracoke facility and activities played an integral part in the active conduct of petitioner's business, we think the airplane constituted a depreciable asset placed in service in 1967 and the investment credit must be allowed.

Expenditures on Machinery

The last issue to be considered is whether certain expenditures made by petitioner during 1965 and 1966 in connection with equipment used in its machine shop and foundry are currently deductible repairs expenses [18] or capital expenditures subject to an allowance for depreciation.[19]

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[18] Income Tax Regs.,

Sec. 1.162-4 Repairs.—The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the cost of acquisition or production or the gain or loss basis of the taxpayer's plant, equipment, or other property, as the case may be, is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with section 167 or charged against the depreciation reserve if such an account is kept.

[19] Income Tax Regs.,

Sec. 1.263(a)-1 Capital expenditures; in general.—

(a) Except as otherwise provided in chapter 1 of the Code, no deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate, or

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made in the form of a deduction for depreciation, amortization, or depletion.

(b) In general, the amounts referred to in paragraph (a) of this section include amounts paid or incurred (1) to add to the

The test to be applied in distinguishing between the two categories is "whether the expenditure materially enhances the value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure." *Plainfield Union Water Co.* v. *Commissioner*, 39 T.C. 333, 338 (1962). But while the test may be simply stated, it draws a rather shadowy line that makes it oftentimes difficult of applicability. Nevertheless, exercising our best judgment on the basis of the evidence placed before us, we have reached the following conclusions.

With respect to the $7,906.88 of expenses incurred in connection with the turret lathe in 1965, $736.29 was paid to adapt the machine to a new and different use and therefore constitutes a capital expenditure. The remaining expenditures were incurred to return the machine to the degree of accuracy required in petitioner's business, i.e., keep it in an ordinarily efficient operating condition. They did not materially add to its value or appreciably prolong its life, and they are currently deductible as ordinary and necessary business expenses. Cf. *Oberman Manufacturing Co.* v. *Commissioner*, 47 T.C. 471 (1967) (expenditure to restore roof to pre-leakage condition, including some structural change, held repairs expense).

The expenditures of $13,661.84 in 1966 for a large number of parts for a wheelabrator machine were also, in our opinion, ordinary and necessary business expenses. Expenditures to replace worn-out parts of a large machine, although capitalized originally as part of the cost of the entire asset, are properly considered repairs expenses

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value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures within the meaning of subparagraphs (1) and (2) of this paragraph. See section 162 and § 1.162-4.

when incurred to merely keep the machine in operating condition. *Libby & Blouin, Ltd.* v. *Commissioner,* 4 B.T.A. 910 (1926).

With respect to the $6,826.00 of expenses incurred in connection with petitioner's lectromelt furnace, however, we sustain respondent's determination. The furnace shell, costing $6,100.00, was a separate unit of the larger machine and itself had a useful life of about 20 years. There was insufficient evidence adduced with respect to the armature for us to decide on which side of the line it falls, and, therefore, the presumption of correctness attached to respondent's determination must prevail.

Decisions will be entered under Rule 155.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 78-1759

BERKLEY MACHINE WORKS & FOUNDRY COMPANY,
Appellees,

versus

COMMISSIONER OF INTERNAL REVENUE,
Appellant.

Appeal from the United States Tax Court, at Washington, D.C.
J. Gregory Bruce, Judge.

Argued October 2, 1979.

Decided June 2, 1980.

Before RUSSELL and PHILLIPS, Circuit Judges, and Roszel C. THOMSEN, Senior United States District Judge, sitting by designation.

Gilbert S. Rothenberg, Tax Division, Department of Justice (M. Carr Ferguson, Assistant Attorney General, Michael L. Paup and Gilbert E. Andrews, Tax Division, Department of Justice on brief) for Appellant; Ellsworth T. Simpson for Appellee.

PHILLIPS, Circuit Judge:

The Commissioner of Internal Revenue appeals from a decision of the United States Tax Court, J. Gregory Bruce, Judge, allowing the taxpayer a deduction of some $100,000 for business entertainment expenses incurred in connection with a hunting and fishing facility it maintained on Ocracoke Island, North Carolina. Because we conclude that the claimed expenses, while undoubtedly business-related, do not meet the strict requirements of section 274 of the In-

ternal Revenue Code of 1954 (as amended in 1962), and that taxpayer has not adequately substantiated the expenses as also required under that section, we reverse.

During the years at issue, 1963-67, taxpayer Berkley Machine Works & Foundry Co. (Berkley) operated a foundry, pattern shop and machine shop located in Norfolk, Virginia. It manufactured machine parts used by other companies in their production process. The company has emphasized, with apparent success, its ability to produce component or repair parts quickly and less expensively than its competitors.

Media advertising is of limited usefulness in such a business, and over the years Berkley has depended on personal contacts and maintenance of congenial working relationships with its customers for the promotion of its business. Berkley's business during these years was concentrated in a small number of major customers. Its sales representatives were each responsible for certain customers on a continuous basis and were encouraged to get acquainted with the employees with whom they would deal in trying to fulfill a customer's requirements.

One of the means developed by Berkley's president, Sam Jones, Sr. to develop and maintain good business relations with its prime customers was the use of a hunting and fishing lodge owned and maintained by the company on Ocracoke Island, North Carolina. The island is a 20-mile-long strip of land roughly mid-way of North Carolina's Outer Banks, with a small village at one end. "Berkley Manor," the company's facility located there, consists of three buildings, each containing a living room, dining room and bedrooms. The largest building has a room with a drafting board, table and chairs, which could be used as a conference room.

On frequent weekends from early spring to late fall, employees from Berkley's major customers and some of

its small ones were invited to Ocracoke for fishing weekends. The testimony indicated that Berkley's officers would decide which customer or customers would be invited for a particular weekend, and the sales representative for that customer would phone a contact of his in a position of authority in that company, who would in turn designate the employees allowed to go. Generally the parties were composed of 15-20 people, frequently from one company but sometimes from two or more different ones. It was not unusual for the wives and children of employees to accompany them (App. 340-41; 344-45). The responsible sales representative would attend, and Sam Jones was usually present during the day, though he spent his nights at his personal residence elsewhere on the island. Most of the trips began on Thursday evening or Friday morning, and lasted through Sunday morning. The guests would spend most of Friday and Saturday fishing on boats chartetred by the company, each of which held four to six people.

The testimony uniformly indicated that business discussions always took place on these trips, though not according to any prearranged agenda. Witnesses for the taxpayer, customer employees who had been present on many of the fishing weekends, stated that business was a subject that came up "anyplace, sometimes on the boat, sometimes in the fishing lodge, sometimes in a room." (App. 157; 234). Another witness indicated that they would "wind up talking shop" when "fishing was poor" and distractions were minimal. (App. 189-90). Sometimes the discussions centered on problems that had arisen in a customer company's production process, and a guest might discuss with a Berkley representative whether certain repair work could be performed or certain parts manufactured. A few witnesses described occasions when they had taken plans or specifications with them to Ocracoke to discuss whether Berkley could make the parts required. But

no witness stated that the weekends were scheduled for the purpose of resolving a particular problem; rather, they took advantage of a previously planned fishing weekend at Ocracoke to bring along business problems that had arisen in the interim. (App. 186-87; 315). And Berkley's Vice President, Sam Jones, Jr., could recall no Ocracoke weekend when written contracts were actually negotiated. (App. 264-65). Taxpayer claimed as business entertainment expenses for the years 1963-67 various expenditures made in providing these trips.

I

Ordinary and necessary business expenses of a taxpayer are deductible under § 162 of the Internal Revenue Code.[1] Business entertainment and travel expenses are governed by this provision, but will be disallowed if they fail to satisfy the more rigorous requirements of § 274(a)[2] as

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[1] All Code references are to the Internal Revenue Code of 1954, as amended.

[2] Sec. 274(a) provides in pertinent part:

§ 1.274 Statutory provisions; disallowance of certain entertainment, etc., expenses.

SEC. 274. Disallowance of certain entertainment, etc., expenses—(a) Entertainment, amusement, or recreation—(1) In general. No deduction otherwise allowable under this chapter shall be allowed for any item—

(A) Activity. With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with, the active conduct of the taxpayer's trade or business, or

(B) Facility. With respect to a facility used in connection with an activity referred to in subparagraph (A), unless the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer's trade or business and that

well as the substantiation provisions of § 274(d). The Tax Court found that Berkley's Ocracoke-related expenditures were sufficiently business-related to satisfy the requirements of § 162, and the record clearly supports that conclusion. The Government does not challenge this finding, or the ruling that the Ocracoke lodge was used "primarily for the furtherance of the taxpayer's trade or business," as required by § 274(a)(1)(B). That provision simply refines the principles of § 162, and may be satisfied if the taxpayer establishes that more than 50 percent of the total calendar days of use of the facility were devoted to business use as defined by § 162, rather than to personal use. Treas. Reg. § 1.274-2(e)(4) (1969); *D.A. Foster Trenching Co* v. *United States,* 473 F.2d 1398, 1400-01 (Ct. Claims 1973).

The central issue on this appeal is whether the character of the business activity at Ocracoke was such that the entertainment deductions claimed with respect to it can be said to have been "*directly* related to the *active* conduct" of Berkley's business, as further required by § 274(a)(1)(B) (emphasis supplied). Additionally, even if that provision is satisfied, taxpayer must have produced adequate substantiation for each item deducted, or the entire deduction must be disallowed under § 274(d). The Tax Court concluded that the deductions were allowable under these provisions, but we disagree.

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the item was directly related to the active conduct of such trade or business, and such deductions shall in no exent exceed the portion of such item directly related to, or, in the case of an item described in subparagraph (A) directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), the portion of such item associated with, the active conduct of the taxpayer's trade or business.

II

Proper application of § 274 requires a consideration of the legislative history accompanying its passage. Support for this section, added to the Code by the Revenue Act of 1962, was generated by a concern that the broad interpretation given the "ordinary and necessary" language of § 162, together with the rule of *Cohan* v. *Commissioner*[3] allowing deduction of an approximation of travel and entertainment expenses, has led to widespread abuse of the deduction provision. The substantiation requirements of § 274(d) were intended to abolish the *Cohan* rule and require the taxpayer to prove the exact amount and circumstance of the deduction; otherwise it would be disallowed entirely.[4]

Another evident purpose of section 274 was to limit the types of business entertainment expenditures otherwise deductible under § 162 by requiring them to meet a more stringent standard of business-relatedness than had theretofore obtained. This purpose is clear in the House Ways and Means Committee Report:

> With respect to expenses for entertainment activities, the bill provides that a deduction will be allowed only to the extent that the taxpayer establishes that the expense was directly related to the active conduct of his trade or business. This means that the taxpayer must show a greater degree of proximate relation between the expenditure and his trade or business than is required under present law. Among other things he will have to show more than a general expectation

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[3] 39 F.2d 540 (2d Cir. 1930). The court there held that a taxpayer who had incurred deductible travel or entertainment expenses but could not prove their exact amount was entitled to a deduction of an approximation of the amount.

[4] H.R. Rep. No. 1477, 87th Cong., 2d Sess. 19 (1962-3 Cum. Bull. 405, 427).

> of deriving some income at some indefinite future time from the making of the entertainment-type expenditure . . . .[5]

This language reveals a clear intent by the House Committee to eliminate deductions for the expense of business entertainment aimed at generating "good will" among present or prospective customers, without necessarily involving any concrete business discussions. *Hippodrome Oldsmobile, Inc.* v. *United States,* 474 F.2d 959 (6th Cir. 1973). The Senate Finance Committee, however, felt the House bill was too harsh on taxpayers and advocated an amendment "to permit the deduction of expenses for goodwill where a close association is established between the expense and the active conduct of a trade or business." It proposed to add the language "or associated with" to the "directly related to the active conduct of the taxpayer's trade or business" requirement in both subsections (A) and (B) of section 274(a). The Senate Report stated: "This new language will permit deduction of expenses for entertainment, amusement, or recreation incurred for the creation or maintenance of business goodwill without regard to whether a particular exception applies."[6]

The Joint Conference Committee Report reveals that a compromise was reached whereby the Senate Committee won on one issue with respect to § 274(a) and lost on the other. The Conference Committee added the Senate language to § 274(a)(1)(A) of the Act, disallowing deductions with respect to an entertainment activity "unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such

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[5] *Id.* at 18; 1962-3 Cum. Bull. at 424.

[6] S. Rep. No. 1881, 87th Cong., 2d Sess. 26, 27 (1962-3 Cum. Bull. 707, 731-32).

item was associated with" the active conduct of the taxpayer's trade or business.[7] But the House Committee language prevailed without addition of the "associated with" qualifying language in § 274(a)(1)(B), concerning general entertainment expenses in connection with facilities, which is the section applicable to this appeal.

Treasury Regulations adopted pursuant to authority granted in § 274(h) provide more insight into the meaning of the "directly related" requirement. Section 1.274-2 (c)(3) provides:

> (3) *Directly related in general.* Except as provided in subparagraph (7) of this paragraph, an expenditure for entertainment shall be considered directly related to the active conduct of the taxpayer's trade or business if it is established that it meets all of the requirements of subdivisions (i), (ii), (iii) and (iv) of this subparagraph.
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> (i) At the time the taxpayer made the entertainment expenditure (or committed himself to make the expenditure), the taxpayer had more than a general expectation of deriving some income or other specific trade or business benefit (other than the goodwill of the person or persons entertained) at some indefinite future time from the making of the expenditure. A taxpayer, however, shall not be required to show that income or other business benefit actually resulted from each and every expenditure for which a deduction is claimed.
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> (ii) During the entertainment period to which the expenditure related, the taxpayer actively engaged in a business meeting, negotiation, discussion, or other bona fide business transaction, other than entertain-

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[7] H. Conf. Rep. No. 2508, 87th Cong., 2d Sess. 16 (1962-3 Cum. Bull. 1129, 1143).

ment, for the purpose of obtaining such income or other specific trade or business benefit (or, at the time the taxpayer made the expenditure or committee himself to the expenditure, it was reasonable for the taxpayer to expect that he would have done so, although such was not the case solely for reasons beyond the taxpayer's control).

(iii) In light of all the facts and circumstances of the case, the principal character or aspect of the combined business and entertainment to which the expenditure related was the active conduct of the taxpayer's trade or business (or at the time the taxpayer made the expenditure or committed himself to the expenditure, it was reasonable for the taxpayer to expect that the active conduct of trade or business would have been the principal character or aspect of the entertainment, although such was not the case solely for reasons beyond the taxpayer's control). It is not necessary that more time be devoted to business than to entertainment to meet this requirement. *The active conduct of trade or business is considered not to be the principal character or aspect of combined business and entertainment activity on hunting or fishing trips or on yachts and other pleasure boats unless the taxpayer clearly establishes to the contrary.*

(iv) The expenditure was allocable to the taxpayer and a person or persons with whom the taxpayer engaged in the active conduct of trade or business during the entertainment or with whom the taxpayer establishes he would have engaged in such active conduct of trade or business if it were not for circumstances beyond the taxpayer's control. For expenditures closely connected with directly related entertainment, see paragraph (d)(4) of this section.

26 C.F.R. § 1.274-2(c)(3) (emphasis supplied).

III

We think it clear that the discussions that took place during the Ocracoke weekends, while certainly business-related and undoubtedly of general economic benefit to Berkley, were not properly established on the evidence as *directly* related to the *active* conduct of its business as contemplated by the statutory language and history and by the Regulations. Witnesses indicated that the trips were valuable to both sides because they provided an opportunity for the development of personal relationships between employees of customer companies and their contacts at Berkley. This tended to smooth the way for a quick resolution of problems that would arise in the course of the companies' business dealings. The practice of mixing employees from different companies on one trip allowed them to compare notes on things that Berkley was doing for their respective companies and may have, somewhere down the road, generated more income for Berkley. Similarly, it may have saved the company money when customers took advantage of their scheduled fishing weekend to bring up problems that had recently surfaced in production schedules or machine operation. None of this evidence, however, indicates that Berkley had, at the time it arranged or took part in the Ocracoke weekends, *more* than a "general expectation of deriving some income or other specific trade or business benefit," other than goodwill, at some indefinite future time.

Two customers did testify that they had on one or more occasions brought plans or specifications along for the purpose of going over specific projects with Berkley representatives. Though this type of activity may constitute a negotiation or discussion for the purpose of obtaining a "specific trade or business benefit" under subparagraph (3)(ii), these discussions were not adequately substantiated under § 274(d), as we discuss below. Because these few specific discussions recalled by customers were inade-

quately substantiated, and the discussions described in the bulk of the trial testimony were informal and general in nature, of the sort that inevitably arise when people whose common bond is business are together, the taxpayer has failed to overcome the presumption stated in subparagraph (3)(iii), that the active conduct of trade or business is considered *not* to be the principal character of combined business and entertainment activity on hunting or fishing trips, unless the taxpayer *clearly establishes to the contrary.* We think that Berkley's evidence, consisting of undocumented recollections by witnesses whose memories were clouded by the passage of time so that most could not positively recall even the *year* when these discussions took place, cannot be considered to establish clearly that the active conduct of business took place on all these occasions. At most it reveals that the benefits derived by Berkley from these weekends were in the area of general business goodwill, exactly the type of expenditure that Congress intended to eliminate as a deduction by means of the directly related test.

Other courts have held that business entertainment primarily directed toward generating goodwill cannot, as a matter of law, be "directly related to the active conduct" of the taxpayer's business. *Handelmann* v. *Commissioner,* 509 F.2d 1067, 1074 (2d Cir. 1975); *Hippodrome Oldsmobile, Inc.* v. *United States,* 474 F.2d 959, 960 (6th Cir. 1973); *St. Petersburg Bank & Trust Co.* v. *United States,* 362 F. Supp. 674 (M.D. Fla. 1973), *aff'd,* 503 F.2d 1402 (5th Cir. 1974). In *Hippodrome,* an automobile agency deducted the expenses of a pleasure boat used for entertaining past and prospective customers. The Sixth Circuit reversed the district court's holding that these expenses met the requirement of sections 162 and 274 of the Code, and held that these were goodwill expenditures clearly disallowed by the directly related test. 474 F.2d at 960. The *Handelmann* court also reversed the Tax Court's allowance of deductions by an attorney of expenses con-

nected with entertainment of clients, past and future, on his yacht, for promotional purposes. The Tax Court in the instant case held these cases inapposite because of factual distinctions, particularly that the taxpayers in both cases generally would not initiate business discussions on the boat trips. Though we recognize the difference between the type of entertainment and the atmosphere in these cases and that provided by Berkley, we do not think they are so significant as to remove the Ocracoke weekends from the same category of goodwill entertainment. Probably the Berkley representatives did at times initiate business discussions (though the testimony concerning such discussions as did take place indicates that they were initiated by the customer) but we do not think that this point is dispositive. The *Hippodrome* court noted that fact only in ruling on the narrow point that the taxpayer had not met the requirement of 26 C.F.R. § 1.274-2(c)(3)(ii), by showing that it had actively engaged in bona fide business transactions during the excursions. 474 F.2d at 965. Nor was this point crucial to the *Handelmann* holding that the taxpayer had not shown more than a general expectation of deriving income at some indefinite future time from his entertainment expenditures. 509 F.2d at 1074. The Treasury Regulations in this area clearly intend that all the facts and circumstances of each case must be considered in determining the character of the business conduct. Though the business discussions at Ocracoke, among businessmen with an ongoing relationship, may have been more concrete than those indicated by the facts in *Hippodrome* and *Handelmann,* there are other considerations, such as the larger number of people, some of whom were not business associates, and the variety of pleasurable distractions, that point to the essentially indirect relationship between these outings and the *active* conduct of taxpayer's business. These factors were significant in the *St. Petersburg Bank* case, in which the bank had a practice of inviting present or potential customers to dove shoots and

barbecues, during which bank employees would circulate among the guests and tout the services of the bank, sometimes discussing specific transactions. 362 F. Supp. at 675. The court nevertheless found that the benefits to the bank were of the goodwill variety and the entertainment did not pass the "directly related" test. *Id.* at 680.[8]

IV

Having determined that the entertainment expenditures related to the operating costs of the Ocracoke facility are not "directly related" expenditures within the meaning of § 274(a)(1)(B), it is appropriate to consider whether cer-

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[8] None of the other subparagraphs of the Regulation section defining "directly related" entertainment is helpful to this taxpayer. The Ocracoke expenditures were not made in a "clear business setting" within the meaning of § 1.274-2(c)(4); this provision applies to entertainment that is clearly subordinate to a business purpose, such as the operation of a hospitality room at a convention. Subparagraph (7) supports this conclusion by providing that certain expenditures are generally considered not directly related, including those where "[t]he distractions were substantial, such as . . . (b) A meeting or discussion, if the taxpayer meets with a group which includes persons other than business associates, at places such as cocktail lounges, country clubs, golf and athletic clubs, or at vacation resorts." This provision tracks the Conference Committee Report, which noted that the rule of the House bill, which prevailed in this section, "would not allow deduction of expenditures for entertainment occurring under circumstances where there is little or no possibility of conducting business affairs or carrying on negotiations or discussions relating thereto, such as where the group of persons entertained is large or the distractions substantial." H. Conf. Rep. No. 2508, 87th Cong., 2d Sess. 16 (1962-3 Cum. Bull. 1129, 1143). Clearly the Ocracoke weekends, involving fairly large groups of people, some of whom were not business associates, and taking place in a setting where the distractions for sportsmen were substantial, were not the "clear business setting" envisioned by Congress. *See. D. A. Foster Trenching Co.* v. *United States*, 473 F.2d 1398, 1402-04 (Ct. Cl. 1973).

tain categories of the Ocracoke expenditures are nevertheless allowable under § 274(a)(1)(A), relating to activities.

Section 1.274-2(e)(3)(iii)(a) of the Regulations provides that certain "out of pocket" expenditures, such as those for food and beverages, are not to be considered as expenditures with respect to a facility, under subsection (B. But the question arises whether these expenses may be allowed as deductions under the more lenient "associated with" test of subsection (A), which as the legislative history reveals, was intended to include goodwill entertainment. This test is expressly qualified, however, by the language that the expense must relate to "an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise) . . . ." The Conference Committee Report that discussed the addition of this language notes as examples of expenses that qualify under this section, the entertainment of a group of business associates at a restaurant, theater or sporting event following substantial negotiations, or the entertainment of out-of-town business associates on the evening before such "substantial business discussions." H. Conf. Rep. No. 2508, 87th Cong., 2d Sess. 17.

The Ocracoke weekends clearly do not come within the statute's contemplation of entertainment that takes place purely as an adjunct to formal business meetings. Nor do we consider that expenses may qualify under the test when the claimed business discussions take place during the course of a combined social/business function. *See St. Petersburg Bank & Trust Co.* v. *United States,* 362 F. Supp. 674, 681 (M.D. Fla. 1973). Thus Berkley's Ocracoke-related expenditures must be considered disallowed under both subsections (A) and (B) of § 274(a)(1).

V

Having concluded that Berkley's contested entertainment deductions must be disallowed under § 274(a), it may not

be strictly necessary to consider separately the Government's argument that the deductions must be disallowed for lack of adequate substantiation under § 274(d). But because we should correct the misapprehension of the Tax Court concerning these substantiation requirements, and because a few of Berkley's witnesses testified to business discussions that might have passed the directly related test had they been adequately substantiated, we also address this point.

Section 274(d) of the Code disallows business entertainment expenses altogether "unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement (A) the amount of such expense . . . , (B) the time and place of the . . . entertainment . . . , (C) the business purpose of the expense . . . , and (D) the business relationship to the taxpayer of persons entertained . . . ." The Treasury Regulations relating to this section state that "adequate records" are an account book, diary, statement of expense or similar record . . . and documentary evidence . . . which, in combination, are sufficient to establish each element of an expenditure . . . ." § 1.274-5(c)(2). Alternatively, if the taxpayer fails to meet the adequate records requirement, he must establish each element "[b]y his own statement, whether written or oral, containing specific information in detail as to such element; and (ii) By other corroborative evidence sufficient to establish such element." § 1-274-5(c)(3). These Regulations have been held lawful and obedient to the legislative intent of § 274, and applied in *Dowell* v. *United States*, 522 F.2d 708, 713 (5th Cir. 1975); *Nicholls, North, Buse Co.* v. *Commissioner*, 56 T.C. 1225, 1234 (1971); *Sanford* v. *Commissioner*, 50 T.C. 823, 830-32 (1968); *aff'd per curiam*, 412 F.2d 201 (2d Cir. 1969).

The statute and the Regulations place a heavy burden on the taxpayer, to substantiate *each* element of *every* deducted item of entertainment expense. *Dowell*, 572 F.2d

at 714; *BJR Corp.* v. *Commissioner,* 67 T.C. 111, 128 (1976); *Fiorentino* v. *Commissioner,* PH Memo T.C., par. 70,316, p. 1583 (1970). This burden was thought to be justified, however, by the abuses of the business entertainment deduction know to be practiced under the old loose standards of § 162 and the *Cohan* rule. The requirement of substantiation allows the Government to double-check the amount and the true business character of the deduction, instead of being forced to rely on the taxpayer's "own unsupported, selfserving testimony." (S. Rep. No. 1881, 87th Cong., 2d Sess. 37).

Berkley presented what the Tax Court found were adequate records of the place, time, and amount of the contested expenditures, and the Government does not challenge the court's findings as to these elements. It does contest Berkley's substantiation of the business purpose of the trips and the business relationship of the guests. The company kept no written diary of the Ocracoke trips describing the business purpose for each, and so had to rely on the testimony of some of its guests to corroborate its own statement that the trips had a business purpose. The taxpayer's own statement, as contained in the testimony of its officers, does not provide the "specific information in detail" required by the Regulations; moreover, the corroborative testimony consisted of testimony by only nine of some 1,000 guests during the relevant years, their testimony related to only 12 of 76 trips, and they could not relate specific business discussions to specific trips. The Tax Court considered this testimony sufficient to establish business purpose in light of the absence of any evidence of personal, non-business use of the facility. But we are of the opinion that this sort of general, often conjectural testimony as to business purpose is exactly the sort of unreliable recollection that the substantiation requirements of § 274(d) were designed to foreclose. *See Rutz* v. *Commissioner,* 66 T.C. 879, 883-84 (1976); *Nicholls, North*

Buse Co. v. *Commissioner*, 56 T.C. 1225, 1235 (1971). The Regulations do allow the corroborative evidence of business purpose to be circumstantial in nature, § 1-274-5(c)(3)(ii); but we do not think that evidence of the nature of the Ocracoke trips in general will support a conclusion that each trip had a business purpose. *Cf. Dowell* v. *United States*, 522 F.2d at 714.

We also conclude that the Tax Court erred in holding that Berkley had adequately substantiated the business relationship of each entertainee at Ocracoke. As the court found, though the taxpayer's witnesses recalled the names of some individual guests, its records contain only a notation of the *company* whose employees were invited down on a particular weekend. To permit the business relationship element to be established by this kind of evidence, when guests had no business relationship with Berkley admittedly attended in response to the corporate invitation, would frustrate the purpose of this element of substantiation, intended to prevent deductions for "business-related" entertainment of persons actually having no business relation to the taxpayer. The Tax Court is not incorrect in its conclusion that "it is the substance of the relationship and not the particular form of record-keeping that substantiates business relationship"; but the required "substance" must be clear from the records if a taxpayer is to get the deduction. A business relationship must be established by identification of each person involved in the entertainment deduction, 26 C.F.R. § 1.274-5(b)(1)(iv); if the relationship is, as was the case in *Rutz* v. *Commissioner*, 66 T.C. 879 (1976), not clear from the name, then the job title should be noted as well. Contrary to the Tax Court's reading, we find *Dowell* v. *United States* in support of this interpretation. Though Dowell's records were inadequate in areas other than the business relationship element, the court's view of the business relationship element was clearly stated: "the business relationship cannot

be ascertained unless the taxpayer establishes the identity of his entertainee—whether by name, title or other specific designation," 522 F.2d at 716. Though on first reading *Nicholls, North, Buse Co.* v. *Commissioner,* 56 T.C. 1225 (1971) seems to indicate that a record of the employer companies would be sufficient to establish business relationship, a closer reading reveals that this was not the ruling of the court. The taxpayer there kept a log in which he wrote the names of the individuals entertained on his boat, sometimes noting the name of their employer as well. *Id.* at 1232. The court simply noted that business relationship arguably might have been proved if the employers of all the guests had been listed in the log. *Id.* at 1235. Thus it was the employer's name in addition to, not instead of, the individual's name, that would have substantiated their business relationship. Certainly a notation of the employer of the individuals entertained by a taxpayer is helpful in establishing the business relationship of the entertainee; but it is not sufficient without some further identification of the individuals themselves. We conclude that Berkley failed to substantiate adequately the business purpose of the Ocracoke trips and the business relationship of its guests; thus the Ocracoke-related deductions must be disallowed under § 274(d) as well as under § 274(a).

VI

One final issue remains for resolution. Included in the total depreciation deduction claimed by Berkley for 1967 is $1,441.46 for an airplane purchased in that year for $86,487.90. The Commissioner disallowed this deduction, as well as an investment credit of $6,054.14 claimed with respect to the airplane, based on his assumption that the airplane was purchased for use in connection with taxpayer's Ocracoke entertainment activities. The Tax Court, having found the Ocracoke activities directly related to the active conduct of taxpayer's business, allowed the deduc-

tion. Other than the testimony of Berkley's accountant that the plane was kept at Norfolk, Virginia and was listed with the Ocracoke assets on Berkley's tax return because there happened to be room for it on that page, there is no evidence in the record as to how the airplane was used. We think the airplane cannot qualify for the investment credit or depreciation deductions because the taxpayer has made no showing that the plane was used in its trade or business or held for the production of income. Internal Revenue Code, §§ 167, 38.

REVERSED.

RUSSELL, Circuit Judge, dissenting:

I dissent for the reasons by the Tax Court, which I think correctly construed the law and the facts herein.

APPENDIX C

Internal Revenue Code, 1954

Sec. 162 Trade or Business Expenses.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

Sec. 274 Disallowance of Certain Entertainment, Expenses.

(a) Entertainment, Amusement, or Recreation.—

(1) In general.—No deduction otherwise allowable under this chapter shall be allowed for any item—

(A) Activity.—With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with, the active conduct of the taxpayer's trade or business, or

(B) Facility.—With respect to a facility used in connection with an activity referred to in subparagraph (A), unless the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of such trade or business,

and such deduction shall in no event exceed the portion of such item directly related to, or, in the case of an item described in subparagraph (A) directly preced-

ing or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), the portion of such item associated with, the active conduct of the taxpayer's trade or business.

(2) Special rules.—For purposes of applying paragraph (1)—

(d) Substantiation Required.—No deduction shall be allowed—

(1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),

(2) for any item with repect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, or

(3) for any expense for gifts,

unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation or use of the facility, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility, or receiving the gift. The Secretary may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations.

Treasury Regulations

Treas. Reg. 1.274-2(c)(3)

(3) Directly related in general. Except as provided in subparagraph (7) of this paragraph, an expenditure for entertainment shall be considered directly related to the active conduct of the taxpayer's trade or business if it is established that it meets all of the requirements of subdivisions (i), (ii), (iii) and (iv) of this subparagraph.

(i) At the time the taxpayer made the entertainment expenditure (or committed himself to make the expenditure), the taxpayer had more than a general expectation of deriving some income or other specific trade or business benefit (other than the goodwill of the person or persons entertained) at some indefinite future time from the making of the expenditure. *A taxpayer, however, shall not be required to show that income or other business benefit actually resulted from each and every expenditure for which a deduction is claimed.* (Emphasis added)

(ii) During the entertainment period to which the expenditure related, the taxpayer actively engaged in a business meeting, negotiation, discussion, or other bona fide business transaction, other than entertainment, for the purpose of obtaining such income or other specific trade or business benefit (or, at the time the taxpayer made the expenditure or committed himself to the expenditure, it was reasonable for the taxpayer to expect that he would have done so, although such was not the case solely for reasons beyond the taxpayer's control).

(iii) In light of all the facts and circumstances of the case, the principal character or aspect of the combined business and entertainment to which the expenditure related was the active conduct of the taxpayer's trade or business (or at the time the taxpayer made the expenditure or committed himself to the expenditure, it was reasonable for the taxpayer to expect that the active conduct

of trade or business would have been the principal character or aspect of the entertainment, although such was not the case solely for reasons beyond the taxpayer's control). *It is not necessary that more time be devoted to business than to entertainment to meet this requirement.* The active conduct of trade or business is considered not to be the principal character or aspect of combined business and entertainment activity on hunting or fishing trips or on yachts and other pleasure boats unless the taxpayer clearly establishes to the contrary. (Emphasis added)

(iv) The expenditure was allocable to the taxpayer and a person or persons with whom the taxpayer engaged in the active conduct of trade or business during the entertainment or with whom the taxpayer establishes he would have engaged in such active conduct of trade or business if it were not for circumstances beyond the taxpayer's control. For expenditures closely connected with directly related entertainment, see paragraph (d)(4) of this section.

(4) Determination of primary use—

(i) In general. A *facility used in connection with entertainment shall be considered as used primarily for the furtherance of the taxpayer's trade or business only if it is established that the primary use of the facility during the taxable year was for purposes considered ordinary and necessary within the meaning of sections 162 and 212 and the regulations thereunder.* All of the facts and circumstances of each case shall be considered in determining the primary use of a facility. Generally, it is the actual use of the facility which establishes the deductibility of expenditures with respect to the facility; not its availability for use and not the taxpayer's principal purpose in acquiring the facility. Objective rather than subjective standards will be determinative. If membership entitles the member's entire family to use of a facility, such as a country club, their use will be considered in determining whether business use of the facility exceeds personal use. The factors

to be considered include the nature of each use, the frequency and duration of use for business purposes as compared with other purposes, and the amount of expenditures incurred during use for business compared with amount of expenditures incurred during use for other purposes. No single standard of comparison, or quantitative measurement, as to the significance of any such factor, however, is necessarily appropriate for all classes or types of facilities. For example, an appropriate standard for determining the primary use of a country club during a taxable year will not necessarily be appropriate for determining the primary use of an airplane. However, a taxpayer shall be deemed to have established that a facility was used primarily for the furtherance of his trade or business if he establishes such primary use in accordance with subdivision (ii) or (iii) of this subparagraph. Subdivisions (ii) and (iii) of this subparagraph shall not preclude a taxpayer from otherwise establishing the primary use of a facility under the general provisions of this subdivision.

. . .

(iii) Entertainment facilities in general. A taxpayer shall be deemed to have established that—

(a) A facility used in connection with entertainment, such as a yacht or other pleasure boat, hunting lodge, fishing camp, summer home or vacation cottage, hotel suite, country club, golf club or similar social, athletic, or sporting club or organization, bowling alley, tennis court, or swimming pool, or,

(b) A facility for employees not falling within the scope of section 274(e)(2) or (5)

was used primarily for the furtherance of his trade or business if he establishes that more than 50 percent of the total calendar days of use of the facility by, or under authority of, the taxpayer during the taxable year were days of business use. Any use of a facility (of a type de-

scribed in this subdivision) during one calendar day shall be considered to constitute a "day of business use" if the primary use of the facility on such day was ordinary and necessary within the meaning of section 162 or 212 and the regulations thereunder. For the purposes of this subdivision, a facility shall be deemed to have been primarily used for such purposes on any one calendar day if the facility was used for the conduct of a substantial and bona fide business discussion (as defined in paragraph (d)(3)(i) of this section) notwithstanding that the facility may also have been used on the same day for personal or familly use by the taxpayer or any member of the taxpayer's family not involving entertainment of others by, or under the authority of, the taxpayer. (Emphasis added)

(iv) Business purpose. Business reason for the entertainment or nature of business benefit derived or expected to be derived as a result of the entertainment and, except in the case of business meals described in section 274(e)(1), the nature of any business discussion or activity;

(v) Business relationship. Occupation or other information relating to the person or persons entertained, including name, title, *or other designation, sufficient to establish business relationship to the taxpayer.* (Emphasis added)

(4) Expenditures in clear business setting. An expenditure for entertainment shall be considered directly related to the active conduct of the taxpayer's trade or business if it is established that the expenditure was for entertainment occurring in a clear business setting directly in furtherance of the taxpayer's trade or business. . . .

Treas. Reg. § 1.274-5

(b) Elements of an expenditure—(1) In General. Section 274(d) and this section contemplate that no deduction shall be allowed for any expenditure for travel, entertainment, or a gift unless the taxpayer substantiates the following elements for each such expenditure:

(i) Amount;

(ii) Time and place of travel or entertainment (or use of a facility with respect to entertainment), or date and description of a gift;

(iii) Business purpose; and

(iv) Business relationship to the taxpayer of each person entertained, using an entertainment facility or receiving a gift.

Federal Rules of Civil Procedure—Rule 52(a)

(a) EFFECT.

. . . Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses.

. . .

APPENDIX D

(R. 154-156)
Direct Testimony of:

Martin Ellers, Vice-President-General Manager, Drill Carrier Corporation.

Q. * * *, calling your attention to the years 1963 to 1967, were you employed during that period of time?

A. I was employed by the Drill Carrier Corporation, Salem, Virginia.

* * * * * * * * * *

A. I was Vice President and General Manager.

* * * * * * * * * *

Q. * * *, directing your attention to the year 1963, did you visit Ocracoke Island, North Carolina, as a guest of Berkley Machine Works?

A. Yes.

Q. Was this also true in the years 1964, 1965, and 1966?

A. Yes.

Q. * * * On these occasions that you were present down on Ocracoke Island as a guest of Berkley Machine Works, were you one of several other guests who went on fishing trips together?

A. Yes.

Q. * * * on occasions that you were a guest of Berkley down on Ocracoke, were there other employees of Drill Carrier also guests at that time?

A. There were.

Q. Can you now recall the names of some of those people who were guests?

A. George Sheppe, John Wood, Bill Goodwin, Carl Kirkjohn, George Temple, George Frye.

(R. 194-195)
Direct Testimony of:

Andrew Scott, Official, American Oil Company.

Q. * * * directing your attention to the year 1963, did you visit Ocracoke Island, North Carolina, as a guest of Berkley Machine Works, * * *?

A. I did.

Q. Were you a guest down there in the year 1964?

A. I was.

Q. And were you a guest down there in 1965?

A. Yes, sir.

Q. 1966?

A. Right.

Q. 1977?

A. Yes, sir.

Q. So you had been there every year from 1963 through 1967, is that correct?

A. That's correct.

Q. On those occasions when you were there, were you one of several other guests who went on fishing trips?

A. I was.

Q. * * * On those occasions when you were down as a guest, were there other employees of the American Oil Company who were also guests on those occasions?

A. Yes.

Q. If you can, tell us their names, * * *

A. I can tell you some: Mark Hopkins, Jack Webb, Cecil Heath, Buddy Wakefield; there are at least six or eight more but right off-hand I can't call.

Q. While you were down there were there * * * other guests from companies other than American Oil Company * * * ?

A. Yes.

Q. Can you recall at the present time who some of those people were?

A. Well, on some occasions there were people there from Union Bag and Camp; there were people there from Ply-

mouth, North Carolina; there were people there from Carrier Corporation. I think at one time or another there were people there from most everyone who had been to Ocracoke and on the fishing parties that I was on.

Q. Can you recall some of the names of the individuals of these other companies that were with you or down at the same time you were there?

A. The companies or the names?

Q. The names of the individuals.

A. Slim Eubanks, Jerry Polk, a fellow we called Big John from over at Union Bag and Camp—I don't recall his last name—a fellow by the name of Duck from Union Bag and Camp.

(R.217-219)
Direct Testimony of:

John Lee Wood, Mechanical Engineer, Drill Carrier Corporation.

Q. * * * Mr. Wood, what is your present occupation or employment?

A. I'm a mechanical engineer. I work for the Gardner Denver Company which has recently acquired the old Drill Carrier Corporation.

* * * * * * * * * * *

Q. Now, directing your attention to the year 1963, did you visit Ocracoke Island, North Carolina, as a guest of Berkley?

A. I believe so.

Q. Would that be also in 1964?

A. That's right.

Q. Is that also true in 1965?

A. Yes, sir.

Q. Did you visit Ocracoke as a guest in 1966, if you recall?

A. Yes, I believe so.

Q. On those occasions, were you one of several other guests who went on fishing trips together on Ocracoke?

A. Yes, sir.

Q. Now, on the occasions that you were a guest, were there other employees of the Drill Carrier Corporation who were also guests of Berkley on Ocracoke Island?

A. Yes, sir.

Q. * * *, if you can recall, tell the Court their names.

A. There was Martin Ellers; there was George Sheppe; Bill Goodman; Carl Kirbjun; Bud Day, I believe, was down there; there was several people from the Gardner Denver Company, our present owner, that went down there at that time. One was vice president of the Company, Don Kipley. I might correct myself—George Day or Bud Day is a distributor of our product. He was with Air Service in Atlanta, Georgia. We had Frank Houchens. I think Mr. Bolayer went one time.

Q. Now, while you were a guest of Berkley do you know whether or not there was employees of other customers of Berkley Machine Works who were also guests at that time?

A. I think on occasion I might have met one or two down there from Union Bag.

Q. Can you recall the names of those two?

A. Well, one in particular is going to be a witness here this morning, Mr. Eubanks.

(R.231-233)
Direct Testimony of:

George B. Sheppe, Finance Manager, Drill Carrier Corporation.

A. Mr. Sheppe, what is your present occupation or employment?

Q. My present occupation is Manager of Finance and Personnel for Gardner Denver Company, Drill Carrier Division.

THE COURT: And Drill Carrier is now called a division of what's the other——

THE WITNESS: Gardner Denver Company.

Q. * * *, directing your attention to the year 1963, did you visit Ocracoke Island, North Carolina, as a guest of Berkley Machine Works and Foundry Company?

A. Yes, I did.

Q. * * * did you visit Ocracoke as a guest in 1964?

A. Yes, I did.

Q. In 1965.

A. Yes, I did.

Q. In 1966 did you also visit Ocracoke as a guest of Berkley Machine Works?

A. Yes, sir.

Q. On those occasions were you one of several other guests who went on fishing trips together?

A. That's true. Yes, sir.

Q. * * * if you can recall, who these other employees were who were at the Ocracoke facilities at the time you were?

A. I can recall a Mr. Martin Ellers who was my boss, John Wood, Carl Kirbjun, Bill Goodwin, Jim Marshall.

(R. 268-269)

Direct Testimony of:

Harvey J. Hubbard, Purchasing Manager, Union Camp Paper Products Company

Q. Directing your attention to the year 1964, did you visit Ocracoke Island, North Carolina, as a guest of Berkley Machine Works and Foundry Company?

A. I would think so. I don't recall exactly the years. I've been a guest at Ocracoke most every year since 1962. Only one or two years I have not been a guest, this being one year of that time, so I feel that I'm correct in saying that I was the guest of Berkley at Ocracoke at that year.

Q. And would that also be true, Mr. Hubbard, with respect to the years 1965, '66 and '67?

A. Yes, sir. It would.

Q. * * * on those occasions that you were a guest of Berkley Machine Works at Ocracoke Island, were there other guests of Berkley's who were employees of Union Bag Camp together on those trips with you?

A. Oh yes. Yes, sir.

Q. * * * if you can, * * * tell us who they were.

A. Well, on each of the trips I've been a guest there we had representatives from our engineering, our maintenance, the manufacturing departments. Normally, they're the department heads or their assistants, so this would be Mr. Ed Rogers, some of his young engineers, such as Jack Harold.

* * * * * * * * * *

A. Slim Eubanks, S. E. Eubanks, Mr. W. T. Dougherty, Mr. J. J. Yirack. Normally there were 14 to 16 of us on each of those occasions and all of them were supervisors of the mill in the various departments that I mentioned.

(R. 288, 290)
Direct Testimony of:

Sam E. Eubanks, Master Mechanic, Union Camp Paper Products.

Q. Mr. Eubanks, what is your present occupation or employment?

A. Master mechanic, and that is in charge of mechanical maintenance, at Union Camp.

* * * * * * * * * *

Q. Directing your attention to the year 1963, did you visit Ocracoke Island, North Carolina as a guest of Berkley Machine Works & Foundry Company?

A. * * * I don't have records, but I'm sure I did. Yes, sir.

Q. Would that also be true in 1964?

A. Well, later '64 or early '65 I had a severe heart attack and I think I did go in '64, and it was possible that I didn't go in '64 or '65, and I can't recall which year it was for sure.

Q. Were you down there as a guest in 1966?

A. I think so, Yes, sir.

Q. * * * on those occasions that you were a guest * * * were there other employees of Union Bag who were guests at that time?

A. Yes, sir.

Q. If you can recall their names, tell the Court who they were.

A. Well at different times there was different people. We have had Mr. Brenner there, Mr. March, Mr. Whitley, Mr. Brown, Mr. Dupree, Mr. Hubbard, Mr. Finley, I believe, Mr. Edwards.

(R. 302, 303, 304, 305)
Direct Testimony of:

Jerry Polk, Maintenance Superintendent,
Weyerhaeuser Corp.

Mr. Polk, what is your present occupation or employment?

A. Maintenance superintendent at the Weyerhaeuser Company in Plymouth. (N.C.)

Q. Directing your attention to the year 1965, did you visit Ocracoke Island as a guest of Berkley Machine Works?

A. Yes, sir.

Q. Directing your attention to the year 1967, did you visit Ocracoke Island as a guest of Berkley Machine Works.

A. Yes, sir.

Q. Now on those occasions that you were a guest * * * at Ocracoke Island, were there other guests who were employees of Weyerhaeuser who accompanied you on those trips?

A. Yes, sir.

Q. Can you recall their names?

A. Jack Leary.

Q. Are there any others?

A. Otha Powell.

* * * * * * * * * *

A. Yes, sir. Bill Statesbury.

A. Yes, sir, Bill Stotesbury.

Brewer.

* * * * * * * * * *

A. They were all in maintenance and engineering.

* * * * * * * * * *

Q. While you were a guest of Berkley Machine Works * * * did you know whether or not there were other employees of other customers of Berkley who were also guests on those occasions?

A. On some occasions there were.

Q. Well, can you remember the names of those other guests who were not employees of Weyerhaeuser?

A. The gentlemen that was just here, Slim Eubanks, was there at one time I remember. Scott who has been a witness was there.

(R. 319, 320, 321)

Direct Testimony of:

M. C. Eddins, Engineer, American Oil Company

Q. Calling your attention to the years 1963 through 1967, where were you employed during that time?

A. I was employed at the American Oil Refinery in Yorktown, Virginia.

Q. Directing your attention to the year 1963, did you visit Ocracoke Island, North Carolina as a guest of Berkley Machine Works?

A. Yes, I did.

Q. Would that also be true for the year 1964?

A. Yes.

Q. Would it also be true for the year 1965?

A. Yes.

Q. And for the year 1966?

Q. And you were also a guest, were you not, again in 1967?

A. Yes, sir. I was.

Q. Now on the occasions that you were a guest, were there other employees of American Oil Company who were also guests of Berkley on Ocracoke Island?

A. Yes there was.

Q. Can you recall their names?

A. Yes. Mr. A. J. Scott, who was also a maintenance supervisor, who has, I've been there with him. Br. Bob Argus, who was plant manager. Mr. Wade Horn, who is the mechanical superintendent in the refinery. And Mr. Carney. He was the general foreman in the refinery.

Q. While you were a guest * * * on Ocracoke Nsland, do you know whether or not there were employees of other customers of Berkley Machine Works who were also guests on those occasions?

A. Yes.

Q. Can you recall the names of some of those people?

A. I didn't get too well acquainted with these people. However, I do remember a Jerry Polk and——

• • • • • • • • • • •

A. Polk I believe was his name. And a man by the name of Eubanks. I believe they called him Slim Eubanks.

(R. 329, 330, 331)
Direct Testimony of:

Richard Harold Deal, Project Engineer,
Albemarle Paper Company.

Q. Mr. Deal, what is your present occupation or employment?

A. I'm a project engineer with Albemarle Paper Company.

• • • • • • • • • • •

Q. Directing your attention to the year 1964, did you visit Ocracoke Island, North Carolina as a guest of Berkley Machine Works?

A. Yes, I did.

Q. On that occasion were you one of several other guests who went on fishing trips?

A. Yes. I was.

Q. * * * while you were there also, were there employees of other customers of Berkley's there?

A. Yes. There were.

Q. Can you recall their names?

A. Only a couple of them John Brenner, who had worked for Johns-Manville who I had formally worked for, and Slim Eubanks, who was, both of them were with Union Camp.

Q. * * * the other employees of Albemarle who were down there with you, can you recall their names?

A. I know that Ray Coker and John Gabriel were there. They were both in the maintenance department, I believe, and Jack Gladstone and perhaps Francis Hanks.

APPENDIX E

(R. 164)
Cross-examination testimony of:

Martin Ellers (Drill Carrier)

Q. Now, Mr. Ellers, do you have any recollection other than the fact that you visited Ocracoke during the years from '63 to '67, when during those years you were there?

A. No, I can't tell you that. I was there during the year but I can't tell you any dates.

Q. Can you tell me whether you were there more than one time a year?

A. Yes. We were sometimes as many as three times in a year.

(R. 194-195)
Cross-examination testimony of:

Andrew Scott (American Oil Company)

Q. Do you remember how many times you went to Ocracoke from 1963 to 1967?

A. In what, four years.

Q. That'd be five years.

A. Five years.

Q. Just approximately.

A. Oh, I would say 12 to 15 times.

(R. 225)
Cross-examination testimony of:

John Lee Wood (Drill Carrier).

Q. Did you keep any sort of records like perhaps a diary or anything about your trip to Ocracoke?

A. No ma'am.

Q. Could you tell me at all how many times you went which year?

A. I'd find that hard to do too, really.

Q. Did you go more than once?

A. We—on occasion we could have gone twice.

(R. 311, 312)
Cross-examination testimony of:

Jerry Polk (Weyerhaeuser)

Q. Now, I believe you testified that you made some visits down to Ocracoke Island during the years 1943 through '67, was that correct?

A. I'm sure I did. I can't pinpoint the dates or the years but I feel sure that I went at that time. Yes.

Q. Now, what about 1963?

A. I feel that I did, but I can't say for sure. It was about that time I went down there. And I've been practically every year since at one time or another.

Q. Would you go more than one time a year?

A. I have. Yes.

(R. 335)
Cross-examination testimony of:

Richard H. Deal (Albemarle Paper Co.)

Q. Mr. Deal, I believe you testified, did you not, that during the years '63 to '67 you visited Ocracoke once and that was in '64, is that correct?

A. I have been down there several times.

Supreme Court, U. S.
FILED
SEP 26 1980
MICHAEL RODAK, JR., CLERK

No. 80-199

In the Supreme Court of the United States

OCTOBER TERM, 1979

BERKLEY MACHINE WORKS & FOUNDRY COMPANY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The question presented in this federal income tax case is whether petitioner satisfied the strict substantiation requirements established by Section 274 of the Internal Revenue Code of 1954 (26 U.S.C.) so as to permit the deduction of expenses it incurred in the operation of a hunting and fishing lodge located on Ocracoke Island, North Carolina.

The pertinent facts may be summarized as follows: Petitioner operates a foundry, pattern shop and machine shop for the manufacturing of metal castings and forgings. It owns a hunting and fishing lodge on Ocracoke Island, located on North Carolina's Outer Banks (Pet. App. 3a-5a, 33a). During 1963-1967, petitioner invited certain of its customers' employees to visit the Ocracoke facility for

hunting and/or fishing weekends. Petitioner's customers would decide which of their employees would be allowed to go, and it was not unusual for these employees to be accompanied on the trips by their wives and children (Pet. App. 6a, 33a-34a).

On audit, the Commissioner concluded that petitioner had not maintained the records required by Section 274 of the Code showing the names of the guests entertained at Ocracoke or the business purpose of each of these fishing weekends. Accordingly, the Commissioner disallowed the business deductions petitioner had claimed with respect to its Ocracoke facility. Petitioner thereafter filed suit in the Tax Court seeking redetermination of the deficiency. In that court, petitioner attempted to supply the missing factual data by offering the testimony of nine witnesses who had been guests at Ocracoke at various times during the years in question. These witnesses testified generally that business matters had come up during these fishing weekends, although not according to any prearranged plan. As one of the witnesses testified, "you wind up talking shop when other things are not happening" or when "fishing was poor" (R. 189-190).[1]

After noting that the trial testimony "provided in detail some of the specific jobs or projects discussed during certain visits to the island" (Pet. App. 27a), the Tax Court held that the Ocracoke visits were directly related to the active conduct of petitioner's business and that the business purpose of the visits and the business relationship of the guests entertained were adequately substantiated within the meaning of Section 274 of the Internal Revenue Code and the Regulations thereunder (Pet. App. 15a-31a).

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[1] "R." refers to the separately bound record appendix filed in the court of appeals.

The court of appeals reversed (Pet. App. 32a-50a). It held that petitioner's Ocracoke expenses "were in the area of general business goodwill," and that, accordingly, the expenses were not "*directly* related to the *active* conduct of its business as contemplated by [Code Section 274's] statutory language and history and by the Regulations" (emphasis in original) (Pet. App. 41a-42a). In addition, the court concluded that petitioner had failed to substantiate the business purpose of each of the 76 trips taken to Ocracoke and the business relationship of the more than 1,000 guests entertained there, as required by Section 274(d) of the Code (Pet. App. 47a).

1. The court of appeals correctly held that petitioner failed to satisfy the substantiation requirements under Section 274 of the Code so as to justify deduction of its hunting and fishing lodge expenses. In 1962, Congress enacted Section 274 to deal with the "widespread abuses" associated with the deductions claimed for "business" entertainment expenses. As the Senate Finance Committee Report noted (S. Rep. No. 1881, 87th Cong., 2d Sess. 25 (1962)), the provision was designed to restrict "deductions for entertainment and traveling expenses * * * to prevent abuses." An important component in this legislation was the adoption of rules designed to eliminate the deduction of entertainment expenses designed mainly to generate "good will"[2] (Pet. App. 28a, 42a). See

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[2]Contrary to petitioner's argument (Pet. 6), in enacting Section 274, Congress specifically intended to bar deduction of entertainment expenses that might have qualified for deduction under the more general requirements of Section 162. As the House Committee Report (H.R. Rep. No. 1447, 87th Cong., 2d Sess. 20 (1962)) indicated:

> With respect to expenses for entertainment activities, the bill provides that a deduction will be allowed only to the extent that the taxpayer establishes that the expense was directly related to the active conduct of his trade or business. This means that the taxpayer must show a greater degree of proximate relation

Hippodrome Oldsmobile, Inc. v. *United States*, 474 F. 2d 959 (6th Cir. 1973). Specifically, Section 274 provides that no deduction shall be allowed for any expenditure relating to the operating costs of an entertainment facility unless the taxpayer not only establishes that the expenditure is directly related to the active conduct of his trade or business, but also substantiates (A) the amount of the expense, (B) the time and place it was incurred, (C) its business purpose, and (D) the business relationship of the persons entertained.[3]

The detailed legislative Regulations promulgated under Section 274 have implemented the congressional purposes. They provide that an expenditure for entertainment, even if business-related within the meaning of Section 162, is not deductible unless "the taxpayer had more than a general expectation of deriving some income or other specific trade or business benefit (other than the goodwill of the person or persons entertained) at some indefinite future time from the making of the expenditure." Treasury Regulations, Section 1.274-2(c)(3)(i).

The court of appeals properly held that the deductions claimed here with respect to "fishing weekends" were barred by Section 274. None of the trips to Ocracoke

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between the expenditure and his trade or business than is required under present law. Among other things he will have to show more than a general expectation of deriving some income at some indefinite future time from the making of the entertainment-type expenditure * * * .

See S. Rep. No. 1881, *supra*, at 25.

[3]The question presented in this case has no continuing importance. Under the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, enacted November 6, 1978, expenses incurred after December 31, 1978, with regard to hunting and fishing lodges are no longer deductible regardless of the extent of the business connection. See Section 361 of the Revenue Act of 1978; H.R. Conf. Rep. No. 95-1800, 95th Cong., 2d Sess. 248-251 (1978).

carried a prearranged business agenda, and the business discussions that occurred there were "informal and general in nature, of the sort that inevitably arise when people whose common bond is business are together" (Pet. App. 42a). Indeed, petitioner's own witnesses could recall only 12 informal business discussions that occurred at all during the five-year period at issue in which 76 separate trips to Ocracoke Island were made (Pet. App. 47a). In these circumstances, the court of appeals correctly held that petitioner's goodwill-oriented expenses relating to the operation of its Ocracoke facility were not directly related to the active conduct of its trade or business. As it stated (Pet. App. 42a; emphasis in original):

> We think that Berkley's evidence, consisting of undocumented recollections by witnesses whose memories were clouded by the passage of time so that most could not positively recall even the *year* when these discussions took place, cannot be considered to establish clearly that the active conduct of business took place on all these occasions. At most it reveals that the benefits derived by Berkley from these weekends were in the area of general business goodwill, exactly the type of expenditure that Congress intended to eliminate as a deduction by means of the directly related test.

See *Handelman* v. *Commissioner*, 509 F. 2d 1067, 1074 (2d Cir. 1975); *St. Petersburg Bank & Trust Co.* v. *United States*, 362 F. Supp. 674 (M.D. Fla. 1973), aff'd, 503 F. 2d 1402 (5th Cir. 1974).

2. Nor was there any substantiation of the business purpose of each of the trips to Ocracoke or the business relationship to petitioner of each of the guests entertained there, as required by Section 274(d). As the Fifth Circuit

has held, petitioner was required to establish, for each of the 76 trips, the "specific business discussed." *Dowell* v. *United States*, 522 F. 2d 708, 709 (5th Cir. 1975), cert. denied, 426 U.S. 920 (1976). Here, however, petitioner failed to establish either the business purpose of each of the trips or the business relationship of the over 1,000 guests entertained at Ocracoke Island during the taxable periods at issue. Indeed, the evidence presented at trial clearly showed that not all of the guests invited to Ocracoke by petitioner's corporate customers had a bona fide business relationship with petitioner. Thus, petitioner failed to furnish even circumstantial proof that substantial business discussions took place on every trip to Ocracoke.[4]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

SEPTEMBER 1980

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[4]Thus, contrary to petitioner's contention (Pet. 9), the decision below does not conflict with *Dowell* v. *United States*, *supra*. There, the taxpayer presented evidence establishing the business purpose of various luncheons and dinners. As in the present case, however, he failed to substantiate "each and every element (amount, date, place, business purpose, and business relationship) of each and every expenditure" (522 F. 2d at 714). Just as in the decision below, the court in *Dowell* disallowed the claimed entertainment expense deductions.

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